

CELL THERAPEUTICS INC
Form 424B5
February 12, 2007
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Filed Pursuant to Rule 424(b)(5)
File No. 333-131533

PROSPECTUS SUPPLEMENT

(to Prospectus dated April 20, 2006)

CELL THERAPEUTICS, INC.

17,645 Shares of Series A 3% Convertible Preferred Stock

Warrants to Purchase 5,275,030 Shares of Common Stock

We are offering 17,645 shares of our Series A convertible preferred stock and warrants to purchase up to 5,275,030 shares of our common stock and 15,825,096 shares of our common stock issuable upon the conversion or exercise of the offered Series A convertible preferred stock and warrants. We will sell our Series A convertible preferred stock and warrants to investors at the negotiated price of \$1,000 per share of Series A convertible preferred stock. Each purchaser of our Series A convertible preferred stock will receive a warrant to purchase approximately 298.95 shares of common stock at an exercise price of \$1.61 per share for each share of Series A convertible preferred stock they purchase in the offering. The warrants are not immediately exercisable and their exercisability is contingent upon the Company obtaining shareholder approval to increase the number of authorized shares of common stock available for issuance.

For a more detailed description of our Series A convertible preferred stock and warrants, see the sections entitled "Description of Series A 3% Convertible Preferred Stock" and "Description of Warrants" beginning on pages S-11 and S-16, respectively. For a more detailed description of our common stock issuable upon the conversion or exercise of the Series A convertible preferred stock and the warrants, see the section entitled "Description of Capital Stock" beginning on page 5 of the accompanying prospectus.

Rodman & Renshaw, LLC acted as the sole placement agent and book runner on this transaction. The placement agent is not purchasing or selling any of these securities nor is it required to sell any specific number or dollar amount of securities, but has agreed to use its best efforts to sell the securities offered by this prospectus supplement.

The Series A convertible preferred stock and the warrants will not be listed on any national securities exchange. Our common stock is quoted on the NASDAQ Global Market and the Nuovo Mercato in Italy under the symbol "CTIC". On February 8, 2007, the last reported sale price of our common stock on the NASDAQ Global Market was \$1.63.

Investing in our convertible preferred stock and warrants involves a high degree of risk. See the section entitled "Risk Factors" beginning on page S-7 of this prospectus supplement.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus supplement is truthful or complete. Any representation to the contrary is a criminal offense.

Shares of	Per Share of	Total
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	Convertible Preferred Stock	Convertible Preferred Stock(1)	
Public offering price of convertible preferred stock and warrants to purchase common stock	17,645	\$ 1,000	\$ 17,645,000
Placement agency fees(2)		\$ 60	\$ 1,058,700
Total proceeds to us before other expenses(2)		\$ 940	\$ 16,586,300

(1) Table excludes shares of common stock issuable on exercise of warrants offered hereby.

(2) A fee equal to 6% of the aggregate proceeds raised in the offering shall be payable to the placement agent.

The convertible preferred stock and warrants will be issued on or about February 12, 2007.

This prospectus supplement is dated February 8, 2007.

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No dealer, salesperson or other person is authorized to give any information or to represent anything not contained in this prospectus supplement or related prospectus or to which we have referred you. You must not rely on any unauthorized information or representations. This prospectus supplement and related prospectus is an offer to sell only the securities offered hereby but only under circumstances and in jurisdictions where it is lawful to do so. The information contained in this prospectus supplement and related prospectus is currently only as of its date, and the information contained in any document incorporated by reference in this prospectus is accurate only as of the date of the document incorporated by reference, regardless of the time of delivery of this prospectus supplement and related prospectus or any sale of a security.

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ABOUT THIS PROSPECTUS

This document is in two parts. The first part is this prospectus supplement, which describes the terms of this offering and also adds to and updates information contained in the accompanying prospectus and the documents incorporated by reference into the accompanying prospectus. The second part is the accompanying prospectus, which gives more general information about the shares of our common stock and other securities we may offer from time to time under our shelf registration statement, some of which may not apply to the securities offered by this prospectus supplement. To the extent there is a conflict between the information contained in this prospectus supplement, on the one hand, and the information contained in the accompanying prospectus or any document incorporated by reference therein, on the other hand, the information in this prospectus supplement shall control.

You should rely only on the information contained or incorporated by reference in this prospectus supplement and contained or incorporated by reference in the accompanying prospectus. We have not authorized anyone, including the placement agent, and the placement agent has not authorized anyone, to provide you with different information. We are offering to sell, and seeking offers to buy, our Series A 3% convertible preferred stock (the convertible preferred stock) and warrants only in jurisdictions where offers and sales are permitted. The information contained or incorporated by reference in this prospectus supplement and contained, or incorporated by reference in the accompanying prospectus is accurate only as of the respective dates thereof, regardless of the time of delivery of this prospectus supplement and the accompanying prospectus, or of any sale of our convertible preferred stock. It is important for you to read and consider all information contained in this prospectus supplement and the accompanying prospectus, including the documents incorporated by reference herein and therein, in making your investment decision. You should also read and consider the information in the documents we have referred you to in *Incorporation of Certain Information by Reference* in this prospectus supplement and *Where You Can Find More Information* in the accompanying prospectus.

Unless otherwise indicated, CTI, Company, we, us, our and similar terms refer to Cell Therapeutics, Inc. and its subsidiaries. CTI and X are our proprietary marks. All other product names, trademarks and trade names referred to in this prospectus supplement and the accompanying prospectus are the property of their respective owners.

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

In addition to the other information contained or incorporated by reference in this prospectus supplement and accompanying prospectus, you should carefully consider the risk factors contained in and incorporated by reference into this prospectus supplement and accompanying prospectus when evaluating an investment in our convertible preferred stock. This prospectus supplement and accompanying prospectus and the documents incorporated by reference into this prospectus supplement and accompanying prospectus include forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended (Exchange Act). All statements other than statements of historical fact are forward-looking statements for purposes of these provisions, including:

any statement regarding the performance, or likely performance, or outcomes or economic benefit of any licensing or other agreement, including any agreement with Novartis Pharma AG or its affiliates, including whether or not such partner will elect to participate, terminate or otherwise make elections, under any such partnership agreement or whether any regulatory authorizations required to enable such agreement will be obtained;

any projections of earnings, revenues or other financial items;

any statements of the plans and objectives of management for future operations;

any statements concerning proposed new products or services;

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any statements regarding future operations, plans, regulatory filings or approvals;

any statements on plans regarding proposed or potential clinical trials or new drug filing strategies;

any statements concerning proposed new products or services, any statements regarding pending or future mergers or acquisitions;
and

any statements regarding future economic conditions or performance, and any statement of assumptions underlying any of the foregoing.

In some cases, forward-looking statements can be identified by the use of terminology such as may, will, expects, plans, anticipates, estimate, potential, or continue or the negative thereof or other comparable terminology. There can be no assurance that such expectations or any of the forward-looking statements will prove to be correct, and actual results could differ materially from those projected or assumed in the forward-looking statements. Our future financial condition and results of operations, as well as any forward-looking statements, are subject to inherent risks and uncertainties, including, but not limited to, the risk factors set forth in this prospectus supplement and the accompanying prospectus, or incorporated by reference herein or therein. All forward-looking statements and reasons why results may differ included in this prospectus supplement are made as of the date hereof, and we assume no obligation to update any such forward-looking statement or reason why actual results might differ.

This prospectus supplement and the accompanying prospectus, contains and incorporates by reference market data, industry statistics and other data that have been obtained from, or compiled from, information made available by third parties. We have not independently verified their data.

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SUMMARY

The following summary highlights information contained elsewhere, or incorporated by reference, in this prospectus supplement and the related prospectus. The following summary does not contain all the information that you should consider before investing in our convertible preferred stock. To understand this offering fully, you should read this entire prospectus supplement and related prospectus carefully, including the financial statements and the documents that we have incorporated by reference into this prospectus.

Our Company

We develop, acquire and commercialize novel treatments for cancer. Our goal is to build a leading biopharmaceutical company with a diversified portfolio of proprietary oncology drugs. Our research, development, acquisition and in-licensing activities concentrate on identifying and developing new, less toxic and more effective ways to treat cancer.

We are developing XYOTAX, paclitaxel poliglumex, for the treatment of non-small cell lung cancer, or NSCLC, and ovarian cancer. As announced in March and May, 2005, our STELLAR 2, 3, and 4 phase III clinical studies for XYOTAX did not meet their primary endpoints of superior overall survival. However, we believe a pooled analysis of STELLAR 3 and 4 demonstrates a statistically significant survival advantage among women receiving XYOTAX when compared to women or men receiving standard chemotherapy. A survival advantage for women over men was also demonstrated in a first-line phase II clinical trial of XYOTAX and carboplatin, known as the PGT202 trial, supporting the potential benefit observed in the STELLAR first-line trials. We believe the lack of safe and effective treatments for women with advanced first-line NSCLC who are performance status 2 represents an unmet medical need. In December 2005, we initiated a phase III clinical trial, known as the PIONEER, or PGT305, study, for XYOTAX as first-line monotherapy in PS2 women with NSCLC. In November 2006, we suspended enrollment in the PIONEER trial to allow data related to recently enrolled patients to mature and to assess the differences in early cycle deaths observed between arms of the study. In December 2006, at the recommendation of the Data Safety Monitoring Board we closed the PGT305 PIONEER lung cancer clinical trial and took patients off both treatment arms. The decision was due, in part, to the utility of the PIONEER trial given our plans to submit a new protocol to the FDA and in light of the aberrantly low rate of deaths in the control group. In early 2007, we submitted a new protocol under a Special Protocol Assessment to the FDA. The new protocol, PGT306, focuses exclusively on NSCLC in PS2 women with normal estrogen levels, the subset of patients where XYOTAX demonstrated the greatest potential survival advantage in the STELLAR trials. We expect this will push back the interim analysis of the trial to the first half of 2008 at the earliest. If the pivotal trial meets its revised pre-specified interim endpoint, we plan to submit a new drug application, or NDA, for XYOTAX for women with advanced NSCLC who are PS2 based on the interim results of the trial with the results of the STELLAR 3 and 4 trials to support the filing. We plan to submit the NDA as soon as practicable following such interim results and would request a priority (six month) review based on the fast track designation. We may be unable to submit an NDA as discussed if the pivotal trial does not meet its revised pre-specified interim endpoint. In Europe, we plan to submit a marketing authorization application, or MAA, based on a non inferior survival and improved side effect profile which we believe was demonstrated in our STELLAR 2, 3, and 4 pivotal trials. The basis for this filing has been reviewed by the Scientific Advice Working Party, or SAWP, at European Medicines Agency, or EMEA.

We are developing pixantrone, a novel anthracycline derivative, for the treatment of non-Hodgkin's lymphoma, or NHL. An interim analysis of our ongoing phase III study of pixantrone, known as the EXTEND study, was performed by the independent Data Monitoring Committee in the third quarter of 2006. Based on their review, the study will continue. Another interim analysis of the study will be performed on approximately 100 patients and is targeted for mid-year 2007.

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We also are developing CT-2106, polyglutamate camptothecin, which is in the phase II component of a phase I/II trial in combination with 5FU/LV for the treatment of colorectal cancer relapsing following FOLFOX therapy.

In September 2006, we entered into an exclusive worldwide licensing agreement with Novartis International Pharmaceutical Ltd., or Novartis, for the development and commercialization of XYOTAX. Total product registration and sales milestones for XYOTAX under the agreement could reach as much as \$270 million. We will not receive any product registration or sales milestone payments under the licensing agreement unless Novartis elects to participate in the development and commercialization of XYOTAX and we receive the necessary regulatory approvals. There is no guarantee that Novartis will make any such election or that we will receive such regulatory approvals. The licensing agreement also provides Novartis with an option to develop and commercialize pixantrone based on certain agreed terms. There is no guarantee that Novartis will exercise this option.

As of September 30, 2006, we had incurred aggregate net losses of approximately \$925.5 million since inception. We expect to continue to incur additional operating losses for at least the next several years.

Recent Developments

2006 Quarterly Reports on Form 10-Q

On January 29, 2007, the audit committee of the board of directors of the company upon recommendation from management and after discussion with our independent auditors, Stonefield Josephson, Inc., concluded that the previously issued consolidated financial statements for the quarters ended March 31, June 30 and September 30, 2006 contained in our quarterly reports on Form 10-Q should not be relied upon because of accounting errors contained therein. The Committee has determined that the unaudited quarterly financial statements for the quarter ended March 31, 2006 included certain overstated settlement and clinical trial expenses of approximately \$1.3 million and the unaudited quarterly financial statements for the quarters ended June 30, 2006 and September 30, 2006 included overstated clinical trial expenses of \$0.5 million and \$0.4 million, respectively. These inadvertent overstatements were discovered by the Company in the fourth quarter of 2006 as a result of an internal review of such accounts at Cell Therapeutics Europe S.r.l., or CTI (Europe), our subsidiary located in Bresso Italy. As a result, we have concluded that the quarterly financial statements for those periods and all our earnings press releases and similar communications relating to those periods should no longer be relied upon by investors. We have also concluded that there were material weaknesses in our internal controls and procedures. On February 6, 2007, we filed amended quarterly reports on Form 10-Q/A containing restated financial statements for those periods correcting these errors.

DOR BioPharma

On January 17, 2007, we sent an unsolicited letter to senior management and the Board of Directors of DOR BioPharma, Inc. (DOR) outlining the potential major terms of a proposed business combination with DOR and the company (the Letter). The Letter was disclosed by DOR via a press release and filing on Form 8-K both dated January 19, 2007. The principal terms of the offer included 29,000,000 shares of CTI stock, a \$15,000,000 contingent value right payable at our option in cash or stock upon FDA approval of orBec[®] and a cash payment to retire DOR s current outstanding warrants. In addition we proposed to provide additional value to DOR shareholders by spinning out or otherwise distributing DOR s biodefense assets to DOR shareholders. In its press release announcing the receipt of the Letter, DOR stated that, pursuant to the terms of an exclusivity agreement it has with a third party, DOR is not currently permitted to discuss the terms of the Letter without the consent of such third party. We do not intend to currently take any further action at this time unless DOR engages in consensual negotiations, which it may not choose to do even if it received the consent of such third party. Even if

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DOR did agree to engage in negotiations with us and received the consent of such third party to do so, the parties may not be able to negotiate acceptable terms for a transaction.

TRISENOX Litigation

In October 2004, we announced that the United States Attorney's Office, or USAO, for the Western District of Washington had initiated an investigation into certain of our business practices relating to TRISENOX, a product which we sold to Cephalon, Inc. for aggregate gross consideration of \$71.9 million in July 2005. We reached an oral agreement in principal with the USAO regarding the material terms of a settlement related to the USAO's investigation. As disclosed in our previous public filings, claims associated with this investigation as well as related conduct have been filed against the company under seal on behalf of the government by a private party in a qui tam action. The final terms and details of this settlement are subject to change and pending the completion and execution of a definitive settlement agreement between us and the USAO, but we understand that the agreement in principal is that we will make a single payment of \$10.5 million to the USAO in return for a release of all government claims in connection with the qui tam action and related matters. We would not make any admission of wrongdoing as part of this settlement. There is no guarantee that we will be able to complete a definitive settlement agreement on the terms of the oral agreement in principal or at all. This settlement does not address separate claims brought against us by the private party plaintiff in such matters, which generally relate to attorney's fees and employment related claims. We believes that claims related to wrongful termination are without merit.

Other Information

We were incorporated in Washington in 1991. Our principal executive offices are located at 501 Elliott Avenue West, Suite 400, Seattle, Washington 98119. Our telephone number is (206) 282-7100. Our website can be found at www.cticseattle.com. Information contained in, or accessible through, our website does not constitute a part of this prospectus supplement.

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The Offering

The following is a brief summary of some of the terms of the offering and is qualified in its entirety by reference to the more detailed information appearing elsewhere in this prospectus supplement and the accompanying prospectus. For a more complete description of the terms of our convertible preferred stock, see the Description of Series A 3% Convertible Preferred Stock section in this prospectus supplement. For a more complete description of the warrants, see the Description of Warrants section in this prospectus supplement. For a more complete description of our common stock, see the Description of Capital Stock section in the accompanying prospectus.

Securities we are offering 17,645 shares of convertible preferred stock and warrants to purchase up to 5,275,030 shares of common stock and up to 15,825,096 shares of common stock issuable upon conversion of the convertible preferred stock and exercise of the warrants. We will sell our convertible preferred stock and warrants in this offering at a negotiated price of \$1,000 per share of convertible preferred stock. Each purchaser of our convertible preferred stock will receive a warrant to purchase approximately 298.95 shares of common stock at an exercise price of \$1.61 per share for each share of convertible preferred stock they purchase in the offering.

Description of Series A 3% convertible preferred stock

Dividends Dividends will be cumulative and will accrue daily from the date of closing of this offering at the annual rate of 3% of the stated value of the convertible preferred stock, payable quarterly on each January 1, April 1, July 1 and October 1 commencing April 1, 2007. The initial stated value of the preferred stock is \$1,000 per share. Any dividends must be declared by our board of directors and must come from funds that are legally available for dividend payments. In the event that funds are not legally available to pay any dividend on the convertible preferred stock, the amount of the stated value of the stock shall be increased by the amount of such unpaid dividend. Dividends on the convertible preferred stock will accrue regardless of whether or not earned or declared and regardless of whether or not we have profits, surplus or other funds legally available for the payment of dividends. Payment of dividends on convertible preferred stock and our common stock are subject to additional restrictions as described under Risk Factors We may not be able to pay cash dividends on any class of capital stock due to legal and contractual restrictions and lack of liquidity.

Optional Conversion The convertible preferred stock can be converted at your option at any time into shares of our common stock at a conversion price determined by dividing the stated value of the convertible preferred stock to be converted into the conversion price, which is initially \$1.6725. The initial conversion price is subject to adjustment in certain events, including a non-stock fundamental change or a common stock fundamental change, which are explained in more detail under the section entitled Description of Series A 3%

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Convertible Preferred Stock Conversion Conversion Price Adjustment Fundamental Transaction.

Mandatory Conversion	On or after August 12, 2007, we may require you to convert up to 100% of your shares of convertible preferred stock if the volume weighted average price of our common stock exceeds 200% of the conversion price for a continuous 20-day period, provided that we meet certain requirements as described under the section entitled Description of Series A 3% Convertible Preferred Stock Conversion Mandatory Conversion.
Limitations on Conversion	We cannot effect a conversion of your convertible preferred stock and you may not request a conversion of your convertible preferred stock if such conversion would result in you and your affiliates owning more than 4.99% of our outstanding common stock after conversion, unless you have specifically requested that such limitation not apply to you. This limitation on beneficial ownership can be waived once by you, on at least 61 days notice, allowing ownership of up to 9.99% of our common stock by you and your affiliates.
Liquidation Preference	In the event of our voluntary or involuntary dissolution, liquidation or winding up, you will be entitled to be paid a liquidation preference equal to the stated value of your convertible preferred stock, plus accrued and unpaid dividends and any other payments that may be due on such shares, before any distribution of assets may be made to holders of capital stock ranking junior to the convertible preferred stock.
Optional Redemption	On or after February 12, 2009, you may redeem the convertible preferred stock, in whole or in part, at your option for the stated value at the time of such redemption, together with accrued but unpaid dividends and other payments that may be due on such shares. See the section entitled Description of Series A 3% Convertible Preferred Stock Redemption Optional Redemption below.
Redemption on the Occurrence of Certain Events	At any time after the occurrence of certain triggering event, as defined in the section entitled Description of Series A 3% Convertible Preferred Stock Redemption Redemption on Triggering Event below, the holders of the convertible preferred stock will be entitled to require redemption of all shares of convertible preferred stock then held by such holder for a redemption amount equal to the greater of (a) 130% of the stated value or (b) the product of (1) the volume weighted average price of the common stock on the trading day prior to the conversion multiplied by (2) the stated value divided by the conversion price; plus all accrued but unpaid dividends or other payments due on such shares.
Voting Rights	The convertible preferred stock will vote on an as-converted basis with the common stock. However, we cannot alter or adversely

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change the rights of the convertible preferred stock, authorize or create any class of senior or parity preferred stock, amend our articles of incorporation or other charter documents in such a way that it would adversely affect the rights of the convertible preferred stock, or increase the number of authorized shares of the convertible preferred stock without the approval of holders of a majority of the convertible preferred stock. In addition, you may have the right to vote as a separate class on certain corporate actions under Washington law.

Description of warrants

Each purchaser of our convertible preferred stock will receive a warrant to purchase approximately 298.95 shares of common stock for each share of convertible preferred stock they purchase in the offering. The warrants are exercisable at an exercise price of \$1.61 per share of our common stock at any time on or after the date upon which a duly authorized amendment to the articles of incorporation of the company to increase the number of authorized shares of common stock to an amount sufficient to permit the issuance of all shares of common stock issuable upon the exercise of the warrants shall have been accepted by the Secretary of State of the State of Washington until the earlier of the second anniversary of such date and February 12, 2012. See Description of Warrants in this prospectus supplement.

Use of proceeds after expenses

We intend to use the proceeds from this offering for general corporate purposes including, without limitation, research and development, preclinical and clinical trials, the preparation and filing of new drug applications and general working capital. See Use of Proceeds in this prospectus supplement.

Market for the convertible preferred stock and warrants

There is no established public trading market for the convertible preferred stock or warrants, and we do not expect a market to develop. In addition, we do not intend to apply for listing the convertible preferred stock or warrants on any securities exchange.

Risk Factors

See Risk Factors and other information included in this prospectus supplement, or incorporated herein by reference, for a discussion of factors you should carefully consider before deciding to invest in the convertible preferred stock, the warrants or our shares of common stock issuable upon conversion of the convertible preferred stock and exercise of the warrants.

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RISK FACTORS

You should carefully consider the risks described below and other information in this prospectus supplement and in the documents incorporated by reference into this prospectus supplement before deciding to invest in our convertible preferred stock. Additional risks and uncertainties that we do not presently know or that we currently deem immaterial may also impair our business, financial condition, operating results and prospects. If any of the following risks actually occur, they could materially adversely affect our business, financial condition, operating results or prospects. In that case, the trading price of our securities could decline.

Please see the information provided under Item 1A Risk Factors of our quarterly report on Form 10-Q/A for the quarterly period ended September 30, 2006, filed with the SEC on February 6, 2007, which is incorporated by reference herein.

Risks Related to this Offering

There is no public market for the convertible preferred stock or warrants to purchase common stock in this offering.

There is no established public trading market for the convertible preferred stock or the warrants being offered in this offering, and we do not expect a market to develop. In addition, we do not intend to apply for listing the convertible preferred stock or the warrants on any securities exchange or for quotation on the NASDAQ Global Market. Without an active market, the liquidity of the convertible preferred stock and the warrants will be limited.

Since we have broad discretion in how we use the proceeds from this offering, we may use the proceeds in ways in which you disagree.

We have not allocated specific amounts of the net proceeds from this offering for any specific purpose. Accordingly, our management will have significant flexibility in applying the net proceeds of this offering. You will be relying on the judgment of our management with regard to the use of these net proceeds, and you will not have the opportunity, as part of your investment decision, to assess whether the proceeds are being used appropriately. It is possible that the net proceeds will be invested in a way that does not yield a favorable, or any, return for our company. The failure of our management to use such funds effectively could have a material adverse effect on our business, financial condition, operating results and cash flow.

The warrants are not immediately exercisable and their exercisability is contingent upon our obtaining shareholder approval of an increase in our authorized shares.

We do not currently have enough authorized shares of common stock underlying the warrants issued in this offering. We currently intend to see shareholder approval of an increase in our authorized shares at a special meeting of our shareholders. We have been seeking shareholder approval of such an increase for an annual meeting which was to have been held in November 2006 but have been unable to hold such a meeting due to our inability to obtain a quorum to conduct business as result of the number of our shares which are held by Italian shareholders who have not voted such shares.

Purchasers of the convertible preferred stock who convert their shares into common stock will incur immediate dilution.

If you convert your shares of convertible preferred stock into or exercise your warrants for shares of common stock, you will experience immediate and substantial dilution because the per share conversion price of your shares of convertible preferred stock and exercise price of your warrants will be higher than the net tangible book value per share of the outstanding common stock immediately after this offering. In addition, you will experience dilution when we issue additional shares of common stock that we are permitted or required to issue under options, warrants, our stock option plan or other employee or director compensations plans.

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If we automatically convert the convertible preferred stock, you should be aware that there is a substantial risk of fluctuation in the price of our common stock from the date we elect to automatically convert to the conversion date.

We may elect to automatically convert the convertible preferred stock if the volume weighted average price of the company's common stock exceeds 200% of the conversion price for each of 20 consecutive trading days. You should be aware that there is a risk of fluctuation in the price of our common stock between the time when we may first elect to automatically convert the preferred and the automatic conversion date.

Automatic conversion will affect your rights and preferences without any action by you.

We may elect to automatically convert the convertible preferred stock without any action taken by you, and we may do so at a time when you do not think it is prudent to convert your convertible preferred stock. Upon conversion, you will lose all preferences to which the convertible preferred stock is entitled, including your liquidation preference and your dividend preference. Moreover, because you will then own common stock, your ownership interest in the company will be diluted.

We may not be able to pay cash dividends on any class of capital stock due to legal and contractual restrictions and lack of liquidity.

Dividends payable on the convertible preferred stock total in the aggregate approximately \$132,338 each quarter. Historically, our earnings have been insufficient to cover our fixed charges and will be insufficient to cover fixed charges and convertible preferred stock dividend payments immediately following the offering. If we were to become profitable, our ability to pay cash dividends on the convertible preferred stock requires the availability of adequate net assets. Even if adequate net assets are available to pay cash dividends on the convertible preferred stock, we may not have sufficient cash flow to cover fixed charges and the convertible preferred stock dividend payments or to permit the payment of convertible preferred stock dividends.

Holders of our convertible preferred stock or warrants will have no rights as a common stockholder until they acquire our common stock.

Until you acquire shares of our common stock upon conversion or exercise of the offered convertible preferred stock and warrants, you will have no rights with respect to our common stock, including rights to respond to tender offers and rights to receive any dividends or other distributions on our common stock. Upon conversion or exercise, you will be entitled to exercise the rights of a common stockholder only as to matters for which the record date occurs after the conversion date. In addition, the warrants are not immediately exercisable and may never become exercisable because their exercisability is contingent upon the company obtaining shareholder approval to increase the number of authorized shares of common stock available for issuance.

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USE OF PROCEEDS

We estimate that the net proceeds of this offering, after deducting placement agent fees and our estimated offering expenses, and excluding the proceeds, if any, from the exercise of the warrants issued in this offering, will be approximately \$16.3 million.

We currently intend to use the net proceeds from this offering for working capital and for general corporate purposes, which may include, among other things, funding research and development, preclinical and clinical trials, the preparation and filing of new drug applications and general working capital.

We cannot estimate precisely the allocation of the net proceeds from this offering among these uses. The amounts and timing of the expenditures may vary significantly, depending on numerous factors, including the progress of our clinical trials and other development efforts as well as the amount of cash used in our operations. Accordingly, our management will have broad discretion in the application of the net proceeds of this offering. We reserve the right to change the use of proceeds as a result of certain contingencies such as competitive developments, opportunities to acquire technologies or products and other factors. Pending the uses described above, we may temporarily invest the net proceeds of this offering in short- and medium-term interest-bearing obligations, investment-grade instruments, certificates of deposit or direct or guaranteed obligations of the U.S. government.

DETERMINATION OF OFFERING PRICE

We will sell our convertible preferred stock and warrants in this offering at a negotiated price of \$1,000 per share of convertible preferred stock. Each purchaser of our convertible preferred stock will receive a warrant to purchase approximately 298.95 shares of common stock at an exercise price of \$1.61 per share for each share of convertible preferred stock they purchase in the offering. Prior to this offering, there was no public market for the convertible preferred stock or the warrants. The terms and conditions of the convertible preferred stock, including the dividend rate and the conversion price, and the warrants, including exercise price, were determined by negotiation by us and the purchasers. The principal factors considered in determining these terms and conditions include:

the market price of our common stock;

the information set forth in this prospectus supplement and accompanying prospectus and otherwise available to the purchasers;

our history and prospects and the history of, and prospects for, the industry in which we compete;

our past and present financial performance and an assessment of our management;

our prospects for future earnings and the present state of our development;

the general condition of the securities markets at the time of this offering;

the recent market prices of, and demand for, publicly traded common stock of generally comparable companies; and

other factors deemed relevant by the purchasers and us.

DIVIDEND POLICY

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We currently intend to pay cash dividends on the convertible preferred stock. Dividends on the convertible preferred stock are cumulative, meaning that if they are not paid they continue to accrue and must be paid prior to the payment of any dividends on our common stock. For a discussion of dividends payable on the convertible preferred stock, please see Description of Series A 3% Convertible Preferred Stock Dividends.

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We have never declared or paid any cash dividends on our common stock and do not currently anticipate declaring or paying cash dividends on our common stock in the foreseeable future. Except for dividends payable on the convertible preferred stock, we currently intend to retain all of our future earnings, if any, to finance operations. Any future determination relating to our dividend policy will be made at the discretion of our board of directors and will depend on a number of factors, including future earnings, capital requirements, financial conditions, future prospects, contractual restrictions and other factors that our board of directors may deem relevant.

RATIO OF EARNINGS TO FIXED CHARGES AND PREFERRED STOCK DIVIDENDS

The following table sets forth our ratio of earnings to fixed charges and preferred dividends for each of the periods indicated.

	Year Ended December 31,					Nine Months Ended September 30,
	2001	2002	2003	2004	2005	2006
Ratio of earnings to fixed charges and preferred stock dividends(1)	(dollars in thousands)					

- (1) Earnings were not sufficient to cover fixed charges and preferred stock dividends equal to the net losses of \$80,273, \$49,903, \$130,031, \$252,298 and \$102,505 for the years ended December 31, 2001, 2002, 2003, 2004 and 2005, respectively, and \$100,219 for the nine months ended September 30, 2006. For this reason, no ratios are provided for these periods. No preferred stock dividends were paid during any of the periods indicated.

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DESCRIPTION OF SERIES A 3% CONVERTIBLE PREFERRED STOCK

The material terms and provisions of the convertible preferred stock being offered pursuant to this prospectus supplement and the accompanying prospectus are summarized below. This summary is subject to, and qualified in its entirety by, the rights, preferences and privileges of the Series A convertible preferred stock set forth in the articles of amendment to our amended and restated articles of incorporation filed as an exhibit to our current report on Form 8-K which we expect to file with the SEC on or about February 12, 2007 in connection with this offering.

Rank

The convertible preferred stock will, with respect to dividend rights and rights upon our liquidation, dissolution or winding up, rank senior to our common stock and the company may not redeem, purchase or otherwise acquire any common stock or other securities of the company junior to the convertible preferred stock except for repurchases of shares of common stock from employees, officers, directors, consultants or others who perform services for the company and who are subject to an agreement with the company providing a right of repurchase of such shares at cost or on the occurrence of certain events, such as termination of employment.

Dividends

Holders of the convertible preferred stock are entitled to receive cumulative dividends at a rate of 3% per annum of the stated value of the convertible preferred stock, to be paid quarterly on each January 1, April 1, July 1 and October 1 with the first such payment to be made on April 1, 2007. The initial stated value of the convertible preferred stock is \$1,000 per share. Dividends will also be paid on the date any shares of the convertible preferred stock are converted with regard to such shares being converted and on the redemption date with regard to shares being redeemed under the optional redemption provisions of the company's articles of incorporation. The dividends shall start accruing on the date of the first issuance of the convertible preferred stock under this prospectus and will be calculated on the basis of a 360-day year, consisting of twelve 30-day periods, and will accrue daily from the date of the closing of this offering. The dividends will be deemed to accrue whether or not earned or declared and whether or not there are profits, surplus or other funds of the company legally available for the payment of dividends. If the company does not have funds legally available for payment of any dividend, that dividend will accrete to and increase the stated value of the convertible preferred stock. If a dividend is not paid within three trading days following the date on which such dividend was to be paid, the dividend shall accrue a late fee, payable in cash, of 18% per annum from the date such payment was due through and including the date such payment is made.

In the event that any dividends due on the convertible preferred stock remain unpaid, the company may not redeem any stock that is junior to or on parity with the convertible preferred stock, nor may it set aside any funds or contribute to a sinking fund for such purpose.

Liquidation Preference

Upon the company's voluntary or involuntary dissolution, liquidation or winding up, holders of the convertible preferred stock will be entitled to receive the stated value of such holder's shares of convertible preferred stock plus any accrued and unpaid dividends and other payments that may be due on the shares before the holders of common stock or any other junior securities of the company receive any payments from such liquidation. In the event the amount available for payment of this liquidation preference is less than the full amount of the stated value of all shares of convertible preferred stock then outstanding, the assets to be distributed to the holders of the convertible preferred stock will be ratably distributed among such holders in accordance with the respective amounts that would be payable on such holder's shares if the liquidation preference was paid in full.

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Conversion

Optional Conversion.

The convertible preferred stock shall be convertible at the option of the holders thereof into registered shares of the company's common stock at anytime after the closing of the transaction into the number of shares of common stock determined by dividing the aggregate stated value of the convertible preferred stock being converted by the conversion price then in effect. The initial conversion price is \$1.6725 and is subject to adjustment as described below. This right to convert is limited by the beneficial ownership limitation described below.

Mandatory Conversion.

At any time after the 6-month anniversary of the closing of this offering, if the volume weighted average price of the company's common stock exceeds 200% of the conversion price for each of 20 consecutive trading days, then the company shall have the right to force the investors to convert up to 100% of the outstanding convertible preferred stock into the number of registered shares of the company's common stock determined by dividing the stated value of the shares to be converted by the conversion price in effect at that time.

Beneficial Ownership Limitation.

The company may not effect any conversion and the holder may not request conversion of the convertible preferred stock if following such conversion the holder and its affiliates would beneficially own in excess of 4.99% of the company's outstanding convertible preferred stock after giving effect to such conversion, unless the holder has elected to not have such limitation be applicable to their investment. The amount of beneficial ownership of the holder and its affiliates will be determined in accordance with Section 13(d) of the Exchange Act and the rules and regulations of that section, except that any convertible preferred stock not being converted will not be included in the calculation of the holder's beneficial ownership. A holder may waive the beneficial ownership limitation one time upon not less than 61 days' notice to the company, and if such limitation is waived, the holder will be allowed to convert shares of the convertible preferred stock provided that such holder and its affiliates do not own more than 9.99% of the company's outstanding common stock after giving effect to such conversion.

Conversion Price Adjustment.

Stock Dividends and Stock Splits. If the company pays a stock dividend or otherwise makes a distribution payable in shares of the common stock on the shares of the common stock or any common stock equivalents, subdivides or combines its outstanding common stock, or reclassifies its common stock in such a way that it issues additional shares of capital stock of the company, the conversion price will be adjusted by multiplying the then existing conversion rate by a fraction the numerator of which is the number of shares outstanding immediately before the distribution, dividend, adjustment or recapitalization and the denominator of which is the number of shares outstanding immediately after such action.

Rights Offerings. If the company issues rights, options or warrants to holders of the common stock giving such holders a right to subscribe for or purchase shares of common stock at a price per share lower than the volume weighted average price of the common stock on the record date for such issuance and does not offer the same rights to the holders of the convertible preferred stock, the conversion price will be adjusted to reflect the rights offering by multiplying such conversion price by a fraction the numerator of which is the number of shares outstanding before such record date plus the number of shares which the aggregate offering price (assuming full subscription) would purchase at the value weighted average price of the common stock on such record date and the denominator of which is the number of shares of common stock outstanding on the record date plus the aggregate number of shares offered for subscription or purchase.

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Pro Rata Distributions. If the company distributes evidences of its indebtedness, assets (including cash or cash dividends), warrants or other rights to subscribe for its securities (other than common stock) to the holders of the common stock, then the conversion price will be adjusted by multiplying the conversion price in effect immediately prior to the record date for such distribution by a fraction the numerator of which is the volume weighted average price of the common stock on such record date minus the fair market value at such record date of the distributed evidence of indebtedness, asset, warrant or other right applicable to one share of common stock, such fair market value to be determined by the board in good faith, and the denominator of which is the volume weighted average price of the common stock on such record date.

Fundamental Transaction. If the company effects a fundamental transaction (as defined below), then upon any future conversion of the convertible preferred stock, the holders will have the right to receive, for each share of common stock they would have received upon such conversion, the same kind and amount of securities, cash or property as such holder would have been entitled to receive in the transaction had it been the holder of a share of common stock immediately prior to the transaction. The term fundamental transaction means any of the following:

a merger or consolidation of the company with or into another entity;

the sale of all or substantially all of the assets of the company in one transaction or a series of related transactions;

any tender offer or exchange offer allowing holders of the common stock to tender or exchange their shares for cash, property or securities, regardless of who makes such offer; or

any reclassification of the common stock or any compulsory share exchange by which the common stock is effectively converted into or exchanged for other securities, cash or property.

If the holders of the common stock are given a choice as to the securities, cash or property to be received in a fundamental transaction, the holders of the convertible preferred stock will be given the same choice on conversion of such holder's shares.

Redemption

Optional Redemption.

On the second anniversary of the closing of this offering, the convertible preferred stock shall be redeemable by any investor at the stated value plus any accrued but unpaid dividends or other payments due on the shares being redeemed. The initial stated value of the convertible preferred stock is \$1,000 per share.

Redemption on Triggering Event.

At any time after the occurrence of a triggering event, as defined below, the holders of the convertible preferred stock will be entitled to require redemption of all shares of convertible preferred stock then held by such holder for a redemption amount equal to the greater of (a) 130% of the stated value or (b) the product of (1) the volume weighted average price of the common stock on the trading day immediately preceding the conversion multiplied by (2) the stated value divided by the conversion price; plus all accrued but unpaid dividends or other payments due on such shares. The term triggering event means the occurrence of any of the following:

the company fails to provide an effective registration statement for the common stock issuable on conversion of the convertible preferred stock, subject to a grace period of 20 calendar days;

the company fails to deliver stock certificates for the common stock issued on a conversion of the convertible preferred stock before the fifth trading day after the certificates are required to be delivered;

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the company provides notice to the holders or public notice that it does not intend to comply with requests for conversion of the convertible preferred stock;

the company fails to have available a sufficient number of authorized and unreserved shares of common stock for issuance on conversion of the convertible preferred stock;

the company fails to observe or perform a covenant, agreement or warranty contained in, or otherwise commits a breach, of the purchase agreement and related transaction documents under which the convertible preferred stock are being sold, and such failure or breach is not cured within 30 calendar days after the company receives notice of such failure or breach;

the company is a party to a change of control transaction which transfers control of greater than 33% of the legal or beneficial ownership of the company or which is a merger, consolidation, sale of assets or similar transaction following which the shareholders of the company immediately prior to the transaction own less than 66% of the aggregate voting power of the surviving or acquiring entity;

the company enters into voluntary or involuntary bankruptcy proceedings that are not dismissed within 60 days, is adjudicated bankrupt or insolvent, has a custodian appointed for any significant part of its assets, makes a general assignment for the benefit of creditors, calls a meeting of its creditors with a view to arranging a composition, adjustment or restructuring of its debts, or acts or fails to act in such a manner that it expressly indicates its consent to, approval of or acquiescence in any such proceedings;

the company's common stock is not listed or quoted for trading on the NASDAQ Global Market or NASDAQ Capital Market for more than 5 trading days, even if such days are not consecutive; or

any monetary judgment, writ or similar final process is entered or filed against the company or a subsidiary or any of its property or assets for greater than \$50,000 and such judgment, writ or similar final process is not vacated, bonded or stayed within 45 calendar days.

Voting Rights

The convertible preferred stock shall have the right to the number of votes equal to the number of shares of common stock issuable upon conversion of the preferred stock, and shall vote with the common stock as a single class except where a separate class vote is required by law. However, the company cannot take any of the following actions without the approval of holders of a majority of the convertible preferred stock:

alter or adversely change the rights of the convertible preferred stock;

authorize or create any class of senior or parity preferred stock with respect to dividends, redemption or distribution of assets on liquidation;

amend the company's articles of incorporation or other charter documents in such a way that it would adversely affect the rights of the convertible preferred stock; or

increase the number of authorized shares of the convertible preferred stock without the approval of holders of a majority of the convertible preferred stock.

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In addition, the company has agreed to not to take any of the following actions without the approval of 67% in stated value of the then outstanding shares of the convertible preferred stock:

amend the articles of incorporation, bylaws or other charter documents of the company so as to materially adversely affect the rights of any holder of the convertible preferred stock;

repay, repurchase or offer to repay or repurchase or otherwise acquire any of its common stock, common stock equivalents or securities junior to the convertible preferred stock except

ⁱ transactions permitted by the purchase agreement and related agreements under which the convertible preferred stock is being sold; or

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- i the repurchase of up to 1,000,000 shares of common stock in any 12-month period from employees, officers, directors, consultants or others performing services for the company or any of its subsidiaries under agreements approved by a majority of the board of directors or under which the company has the option to repurchase such shares at cost or at cost on the occurrence of certain events such as termination of employment;

pay cash dividends or distributions on any securities of the company junior to the convertible preferred stock; or

enter into any agreement or understanding to take any of the actions listed above.

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DESCRIPTION OF WARRANTS

The material terms and provisions of the warrants being offered pursuant to this prospectus supplement and the accompanying prospectus are summarized below. This summary is subject to, and qualified in its entirety by, the form of warrant filed as an exhibit to our current report on Form 8-K, which we expect to file with the SEC on or about February 12, 2007.

The warrants will be exercisable on or after the date upon which all necessary corporate and shareholder action to approve an amendment to the articles of incorporation of the company to increase the number of authorized shares of common stock to an amount sufficient to permit the issuance of all shares of common stock issuable upon the exercise of the warrants shall have been taken and such amendment shall have been accepted by the Secretary of State of the State of Washington. The warrants will terminate on the earlier to occur of the second anniversary of the date upon which the warrants become exercisable and February 12, 2012. The warrants will be exercisable, at the option of each holder, upon the surrender of the warrants to us and the payment in cash of the exercise price of the shares being acquired upon exercise of the warrants.

The exercise price per share of common stock purchasable upon exercise of the warrants is \$1.61 per share of common stock being purchased. The exercise price is subject to appropriate adjustment in the event of stock dividends, stock splits, reorganizations or similar events affecting our common stock. The holders of the warrants are entitled to 20 days' notice before the record date for certain distributions to holders of our common stock. If certain fundamental transactions occur, such as a merger, consolidation sale of substantially all of our assets, tender offer or exchange offer with respect to our common stock or reclassification of our common stock, the holders of the warrants will be entitled to receive thereafter in lieu of our common stock, the consideration (if different from common stock), that the holders of our common stock received due to such fundamental transaction.

As of the date of this prospectus supplement, warrants to purchase 800,000 shares of the company's common stock were outstanding.

CERTAIN U.S. FEDERAL INCOME TAX CONSIDERATIONS

All purchasers of the convertible preferred stock and warrants are advised to consult their own tax advisors regarding the federal, state, local and foreign tax consequences of the purchase, ownership, conversion, exercise and disposition of the convertible preferred stock or warrants in their particular situations.

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PLAN OF DISTRIBUTION

We are offering through Rodman & Renshaw, LLC, who acted as our sole placement agent (the "placement agent"), 17,645 shares of our convertible preferred stock at a purchase price of \$1,000 per share to investors. In addition, each investor in the offering will receive warrants to purchase shares of our common stock, at an exercise price of \$1.61 per share. In connection with this offering, we will pay fees to the placement agent. The placement agent will be working solely on a "best efforts" basis and is not purchasing or selling any shares by this prospectus supplement or the accompanying prospectus, nor is it required to arrange for the purchase and sale of any specific number or dollar amount of shares. Therefore, we may not sell the entire amount of shares of our convertible preferred stock and warrants offered pursuant to this prospectus supplement.

The securities purchase agreement provides that the obligations of the investors in the offering are subject to certain conditions precedent, including the absence of any material adverse change in our business and the receipt o