FORMFACTOR INC
Form DEF 14A
April 08, 2009

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

# SCHEDULE 14A

Proxy Statement Pursuant to Section 14(a) of
the Securities Exchange Act of 1934 (Amendment No. )

Filed by the Registrant ý

Filed by a Party other than the Registrant o

Check the appropriate box:

o Preliminary Proxy Statement

o **Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))**

ý Definitive Proxy Statement

o Definitive Additional Materials

o Soliciting Material Pursuant to §240.14a-12

**FORMFACTOR, INC.**

(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

ý No fee required.

o Fee computed on table below per Exchange Act Rules 14a-6(i)(1) and 0-11.
(1) Title of each class of securities to which transaction applies:

(2) Aggregate number of securities to which transaction applies:

(3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (set forth the amount on which the filing fee is calculated and state how it was determined):

(4) Proposed maximum aggregate value of transaction:

(5) Total fee paid:

o Fee paid previously with preliminary materials.

o Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

(1) Amount Previously Paid:

(2) Form, Schedule or Registration Statement No.:

(3) Filing Party:

(4) Date Filed:

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# FORMFACTOR, INC.

**7005 Southfront Road**
**Livermore, California 94551**

April 8, 2009

**2009 ANNUAL MEETING OF STOCKHOLDERS**

To Our Stockholders:

You are cordially invited to attend the 2009 Annual Meeting of Stockholders of FormFactor, Inc., which will be held at our principal executive offices located at 7005 Southfront Road, Livermore, California 94551, on Wednesday, May 20, 2009, at 3:00 p.m., Pacific Daylight Time.

The agenda for the Annual Meeting is described in detail in the attached Notice of Annual Meeting of Stockholders and the attached Proxy Statement. We urge you to carefully review the attached proxy materials.

**Your vote is important. Whether or not you are able to attend the Annual Meeting in person, we urge you to vote your shares through the Internet in accordance with the instructions in the Notice of Internet Availability of Proxy Materials that you received in the mail, or by signing, dating, and returning a proxy card at your earliest convenience.**

We thank you for your continued support. We look forward to seeing you at our 2009 Annual Meeting of Stockholders.

With best regards,

Dr. Mario Ruscev
*Chief Executive Officer*

Livermore, California
April 8, 2009

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# FORMFACTOR, INC.

**7005 Southfront Road**
**Livermore, California 94551**

**NOTICE OF 2009 ANNUAL MEETING OF STOCKHOLDERS**
To Be Held May 20, 2009
At 3:00 p.m., Pacific Daylight Time

To Our Stockholders:

NOTICE IS HEREBY GIVEN that the 2009 Annual Meeting of Stockholders of FormFactor, Inc. will be held at our principal executive offices located at 7005 Southfront Road, Livermore, California 94551, on Wednesday, May 20, 2009, at 3:00 p.m., Pacific Daylight Time, for the following purposes:

1. To elect two Class III directors to our Board of Directors, each to serve on our Board of Directors until his successor has been elected and qualified or until his earlier death, resignation or removal. The director nominees are:
   James A. Prestridge and
   Harvey A. Wagner.

2. To ratify the selection of PricewaterhouseCoopers LLP as FormFactor's independent registered public accounting firm for fiscal year 2009.

3. To act upon such other matters as may properly come before the Annual Meeting or any adjournment or postponement thereof.

The foregoing items of business are more fully described in the Proxy Statement for the 2009 Annual Meeting of Stockholders accompanying this Notice.

The record date for determining those stockholders of our company who will be entitled to notice of, and to vote at, the Annual Meeting and at any adjournment or postponement thereof is March 31, 2009. A list of those stockholders entitled to vote at the Annual Meeting will be available for inspection by any of our stockholders for any purpose germane to the Annual Meeting during regular business hours at FormFactor's principal executive offices for ten days prior to the Annual Meeting.

**Your vote is important. Whether or not you are able to attend the Annual Meeting in person, we urge you to vote your shares through the Internet in accordance with the instructions in the Notice of Internet Availability of Proxy Materials that you received in the mail, or by signing, dating, and returning a proxy card at your earliest convenience.**

On behalf of our Board of Directors, thank you for your participation in our 2009 Annual Meeting of Stockholders.

BY ORDER OF THE BOARD OF DIRECTORS

Stuart L. Merkadeau
*Secretary*

Livermore, California
April 8, 2009

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The information in the Report of the Audit Committee and the Report of the Compensation Committee contained in this Proxy Statement shall not be deemed to be incorporated by reference into any filing under the Securities Act of 1933, as amended, or under the Securities Exchange Act of 1934, as amended, except to the extent that we specifically incorporate this information by reference into such filings. In addition, this information shall not otherwise be deemed to be "soliciting material" or to be filed under those Acts.

Please note that information on FormFactor's website is not incorporated by reference in this Proxy Statement.

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# FORMFACTOR, INC.

**7005 Southfront Road**
**Livermore, California 94551**

**PROXY STATEMENT**
**FOR**
**2009 ANNUAL MEETING OF STOCKHOLDERS**

April 8, 2009

## GENERAL INFORMATION

**Why am I receiving FormFactor's proxy materials?**

Our Board of Directors has made FormFactor's proxy materials available to you on the Internet on or about April 8, 2009 or, upon your request, has delivered a printed set of the proxy materials to you by mail in connection with the solicitation of proxies by our Board for our 2009 Annual Meeting of Stockholders. FormFactor's proxy materials are available on the Internet at *www.edocumentview.com/FORM*. We will hold the Annual Meeting at our principal executive offices located at 7005 Southfront Road, Livermore, California 94551, on Wednesday, May 20, 2009, at 3:00 p.m., Pacific Daylight Time.

**What is included in the proxy materials?**

The proxy materials include our company's Notice of Annual Meeting of Stockholders, Proxy Statement and 2008 Annual Report, which includes our audited consolidated financial statements. If you requested a printed set of the proxy materials by mail, the proxy materials also included a proxy card for the Annual Meeting.

**What specific proposals will be considered and acted upon at FormFactor's 2009 Annual Meeting?**

The specific proposals to be considered and acted upon at the Annual Meeting are:

*Proposal No. 1* Election of two Class III directors to our Board of Directors, each to serve on our Board until his successor has been elected and qualified or until his earlier death, resignation or removal. The director nominees are: James A. Prestridge and Harvey A. Wagner; and

*Proposal No. 2* Ratification of the selection of PricewaterhouseCoopers LLP as our independent registered public accounting firm for fiscal year 2009.

We will also consider any other matters that are properly presented for a vote at the Annual Meeting.

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**What are the voting recommendations of our Board of Directors?**

Our Board of Directors recommends a vote FOR each of Proposal No. 1 and 2. Specifically, our Board recommends a vote FOR:

Election of James A. Prestridge and Harvey A. Wagner to our Board of Directors as Class III directors; and

Ratification of the selection of PricewaterhouseCoopers LLP as our independent registered public accounting firm for fiscal year 2009.

**Why did I receive a notice in the mail regarding the Internet availability of the proxy materials?**

We mailed a Notice of Internet Availability of Proxy Materials to our stockholders of record and beneficial owners of our common stock on or about April 8, 2009 to notify you that you can access the proxy materials over the Internet. Instructions for accessing the proxy materials through the Internet are set forth in the Notice of Internet Availability of Proxy Materials. As we did last year for our 2008 Annual Meeting of Stockholders, we sent the Notice instead of mailing a printed set of the proxy materials in accordance with the "Notice and Access" rules adopted by the U.S. Securities and Exchange Commission. If you wish to receive a printed set of the proxy materials, please follow the instructions set forth on the Notice of Internet Availability of Proxy Materials.

**How can I get electronic access to the proxy materials?**

The Notice of Internet Availability of Proxy Materials contains instructions for how to review our company's proxy materials on the Internet and to instruct us to send future proxy materials to you by e-mail. Your election to receive future proxy materials by e-mail will remain in effect until you terminate it in writing.

**Who can vote at the Annual Meeting?**

Only stockholders of record of our common stock at the close of business on March 31, 2009, which is the record date, are entitled to notice of, and to vote at, the Annual Meeting. If you own shares of FormFactor common stock as of the record date, then you can vote at the Annual Meeting. At the close of business on the record date, we had 49,341,979 shares of our common stock outstanding and entitled to vote, which were held by 79 stockholders of record.

**How many votes am I entitled per share of common stock?**

Holders of our common stock are entitled to one vote for each share held as of the record date.

**What is the difference between holding FormFactor shares as a stockholder of record and a beneficial owner?**

Most of our stockholders hold their shares of our common stock as a beneficial owner through a broker, bank or other nominee in "street name" rather than directly in their own name. As summarized below, there are some important distinctions between shares held of record and those owned beneficially in "street name."

*Stockholder of Record:* If your shares of our common stock are registered directly in your name with our transfer agent, Computershare Trust Company, N.A., you are considered the stockholder of record with respect to those shares, and we delivered the Notice of Internet Availability of Proxy Materials directly to you. As the stockholder of record, you have the right to vote your shares in person or by proxy at the Annual Meeting.

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*Beneficial Owner:* If your shares of our common stock are held in an account with a broker, bank or other nominee, you are considered the beneficial owner of those shares held in "street name," and the nominee holding your shares on your behalf delivered the Notice of Internet Availability of Proxy Materials to you. The nominee holding your shares is considered the stockholder of record for purposes of voting at the Annual Meeting. As the beneficial owner, you have the right to direct your broker, bank or other nominee how to vote your shares being held by them.

**What do I need to bring with me to attend the Annual Meeting?**

If you are a stockholder of record of shares of our common stock, please bring photo identification with you. If you are a beneficial owner of shares of our common stock held in "street name," please bring photo identification and the "legal proxy," which is described below under the question "If I am a beneficial owner of shares held in 'street name,' how do I vote?", or other evidence of stock ownership (e.g., most recent account statement) with you. If you do not provide photo identification or if applicable, evidence of stock ownership, you will not be admitted to the Annual Meeting.

**If I am a stockholder of record of FormFactor shares, how do I vote?**

*Voting by Internet.* You can vote through the Internet by following the instructions provided in the Notice of Internet Availability of Proxy Materials that you received. Go to *www.envisionreports.com/FORM*, follow the instructions on the screen to log in, make your selections as instructed and vote.

*Voting by Mail.* You can vote by mail by requesting a printed set of the proxy materials, which will contain a proxy card, and by then completing, dating, signing and returning the proxy card in the postage-paid envelope (to which no postage need be affixed if mailed in the United States) accompanying the proxy card.

*Voting in Person.* If you plan to attend the Annual Meeting and vote in person, we will give you a proxy card at the Annual Meeting. Even if you plan to attend the Annual Meeting, we encourage you also to vote by Internet or mail as described above so that your vote will be counted if you later decide not to attend the Annual Meeting.

**If I am a beneficial owner of shares held in "street name," how do I vote?**

*Voting by Internet.* You can vote through the Internet by following the instructions provided in the Notice of Internet Availability of Proxy Materials that you received. Go to *www.proxyvote.com*, follow the instructions on the screen to log in, make your selections as instructed and vote.

*Voting by Mail.* You can vote by mail by requesting a printed set of the proxy materials, which will contain a voting instruction form, and by completing, dating, signing and returning the voting instruction form in the postage-paid envelope (to which no postage need be affixed if mailed in the United States) accompanying the voting instruction form.

*Voting in Person.* If you plan to attend the Annual Meeting and vote in person, you must obtain a "legal proxy" giving you the right to vote the shares at the Annual Meeting from the broker, bank or other nominee that holds your shares. Even if you plan to attend the Annual Meeting, we recommend that you also vote by Internet or mail as described above so that your vote will be counted if you later decide not to attend the Annual Meeting.

**Where will the Annual Meeting be held?**

We will hold the Annual Meeting at our principal executive offices located at 7005 Southfront Road, Livermore, California 94551, on Wednesday, May 20, 2009, at 3:00 p.m., Pacific Daylight Time. From San Francisco, CA, take I-80 East, merge onto I-580 East, take N. Greenville Road/

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Altamont Pass Road exit, turn right on the ramp onto Southfront Road and turn left into the Company's headquarters. From San Jose, CA, take I-880 North, merge onto Mission Boulevard/CA-262 East, merge onto I-680 North, merge onto I-580 East, take N. Greenville Road/Altamont Pass Road exit, turn right on the ramp onto Southfront Road and turn left into the Company's headquarters.

**What if I submit a proxy but I do not give specific voting instructions?**

*Stockholder of Record:* If you are a stockholder of record of shares of our common stock and if you indicate when voting through the Internet that you wish to vote as recommended by our Board of Directors, or if you sign and return a proxy without giving specific voting instructions, then the proxy holders designated by our Board, who are officers of our company, will vote your shares for the Class III nominees for director and for the selection of PricewaterhouseCoopers LLP as our independent registered public accounting firm for fiscal year 2009, both as recommended by our Board of Directors and as presented in this Proxy Statement.

*Beneficial Owner:* If you are a beneficial owner of shares of our common stock held in "street name" and do not present the broker, bank or other nominee that holds your shares with specific voting instructions, then the nominee may generally vote your shares on "routine" proposals but cannot vote on your behalf for "non-routine" proposals under the rules of various securities exchanges. If you do not provide specific voting instructions to the nominee that holds your shares with respect to a non-routine proposal, the nominee will not have the authority to vote your shares on that proposal. When a broker indicates on a proxy that it does not have authority to vote shares on a particular proposal, the missing votes are referred to as "broker non-votes." We understand that Proposals No. 1 and 2 involve matters that are considered "routine" under applicable rules.

**What is the quorum requirement for the Annual Meeting?**

A quorum is required for our stockholders to conduct business at the Annual Meeting. A majority of the outstanding shares of our common stock entitled to vote on the record date must be present in person or represented by proxy at the Annual Meeting in order to hold the meeting and conduct business. We will count your shares for purposes of determining whether there is a quorum if you are present in person at the Annual Meeting, if you have voted through the Internet, if you have voted by properly submitting a proxy card or if the nominee holding your shares submits a proxy card. We will also consider broker non-votes for the purpose of determining if there is a quorum.

**What is the voting requirement to approve each of the proposals?**

For Proposal No. 1, the Class III directors will be elected by a plurality of the votes cast by the holders of shares of our common stock entitled to vote who are present in person or represented by proxy at the Annual Meeting. You may not cumulate votes in the election of directors.

Approval of Proposal No. 2 requires the affirmative vote of a majority of the votes cast by the holders of shares of our common stock entitled to vote that are present in person or represented by proxy at the Annual Meeting.

The effectiveness of any of the proposals is not conditioned upon the approval by our stockholders of any other proposal by our stockholders.

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**How are abstentions treated?**

Abstentions are counted for the purposes of determining whether a quorum is present at the Annual Meeting. Abstentions will not be counted either in favor of or against the election of the Class III director nominees or the ratification of the selection of our independent registered public accounting firm for fiscal year 2009.

**Can I change my vote or revoke my proxy after I have voted?**

You may change your vote or revoke your proxy at any time before the final vote at the Annual Meeting. You may vote again on a later date (a) through the Internet (only your latest Internet proxy submitted prior to the Annual Meeting will be counted), (b) by signing and returning a new proxy card with a later date if you are a stockholder of record, or (c) by attending the Annual Meeting and voting in person if you are a stockholder or record or if you are a beneficial owner and have obtained a proxy giving you the right to vote your shares from the nominee holding your shares. However, your attendance at the Annual Meeting will not automatically revoke your proxy unless you vote again at the Annual Meeting or specifically request in writing that your prior proxy be revoked.

**Is my vote confidential?**

Proxy instructions, ballots and voting tabulations that identify individual stockholders are handled in a manner that protects your voting privacy. Your vote will not be disclosed either within our company or to third parties, except (a) as necessary to meet applicable legal requirements, (b) to allow for the tabulation and certification of votes, and (c) to facilitate a successful proxy solicitation. Occasionally, stockholders provide written comments on their proxy cards, which we may forward to our company's Corporate Secretary.

**What happens if additional matters are presented at the Annual Meeting?**

Other than Proposals No. 1 and 2, we are not aware of any other matters to be presented for a vote at the Annual Meeting. If you grant a proxy, the proxy holders, who are officers of our company, will have the authority in their discretion to vote your shares on any other matters that are properly presented for a vote at the Annual Meeting. If for any reason any of the Class III nominees is not available as a candidate for director, the proxy holders will vote your proxy for such other candidate or candidates as may be recommended by our Board of Directors.

**What happens if there are insufficient votes in favor of the proposals?**

In the event that sufficient votes in favor of the proposals are not received by the date of the Annual Meeting, the proxy holders, who are officers of our company, may propose one or more adjournments of the Annual Meeting to permit further solicitations of proxies. Any such adjournment would require the affirmative vote of holders of the majority of the shares of common stock present in person or represented by proxy at the Annual Meeting.

**Where can I find the voting results of the Annual Meeting?**

We intend to announce the voting results at the Annual Meeting and to publish the results in our quarterly report on our Form 10-Q for the fiscal quarter ending on June 27, 2009 and/or other filings with the U.S. Securities and Exchange Commission.

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**Who is paying for the cost of this proxy solicitation?**

We will pay the entire cost for soliciting proxies to be voted at the Annual Meeting. We will pay brokers, banks and other nominees representing beneficial owners of shares of our common stock held in "street name" certain fees associated with delivering the Notice of Internet Availability of Proxy Materials, delivering printed proxy materials by mail to beneficial owners who request them and obtaining beneficial owners' voting instructions. In addition, our directors, officers and employees may also solicit proxies on our behalf by mail, telephone or in person. We will not pay any compensation to our directors, officers and employees for their proxy solicitation efforts, but we may reimburse them for reasonable out-of-pocket expenses in connection with any solicitation. In addition, we may engage a proxy solicitor to assist in the solicitation of proxies. If we engage a proxy solicitor, we expect that the fees we would pay to the proxy solicitor would not exceed $5,000, plus reasonable out-of-pocket expenses.

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**PROPOSAL NO. 1**

**ELECTION OF CLASS III DIRECTORS**

The first proposal is to elect two Class III directors to our Board of Directors. The Class III nominees are James A. Prestridge and Harvey A. Wagner, who are current directors of FormFactor. These nominees have been duly recommended by our Governance Committee and duly nominated by our Board of Directors, and have agreed to stand for re-election. The proxy holders intend to vote all proxies received for Messrs. Prestridge and Wagner, unless otherwise instructed. Proxies may not be voted for more than two directors. Stockholders may not cumulate votes in the election of directors. In the event any nominee is unable or declines to serve as a director at the time of the Annual Meeting, the proxies may be voted for a nominee designated by our Board of Directors to fill the vacancy. As of the date of this Proxy Statement, our Board of Directors is not aware that any nominee is unable or will decline to serve as a director of our company.

**Our Board of Directors recommends a vote FOR the election of James A. Prestridge and Harvey A. Wagner to our Board of Directors as Class III directors.**

**Board of Directors**

Our Board of Directors consists of eight members and is divided into three classes, which we have designated as Classes I, II and III. Each director is elected for a three-year term of office, with one class of directors being elected at each annual meeting of stockholders. The Class III directors will be elected at the Annual Meeting, the Class I directors will be elected at our 2010 Annual Meeting of Stockholders and the Class II directors will be elected at our 2011 Annual Meeting of Stockholders. Each director holds office until his or her successor is duly elected and qualified or until his or her earlier death, resignation or removal.

Information regarding our Class III and other directors, including their names and positions with our company, is set forth in the table below.

| Name of Director | Age | Class | Position with FormFactor | Director Since |
|---|---|---|---|---|
| Dr. Homa Bahrami(2)(3) | 54 | II | Director | December 2004 |
| Dr. Thomas J. Campbell(3) | 56 | I | Director | January 2006(5) |
| G. Carl Everett, Jr.(1)(2)(4) | 58 | II | Director | June 2001 |
| Dr. Igor Y. Khandros | 54 | I | Executive Chairman of the Board of Directors | April 1993 |
| Lothar Maier(2)(4) | 54 | I | Director | November 2006 |
| James A. Prestridge(1)(2)(4) | 77 | III | Lead Independent Director | April 2002 |
| Dr. Mario Ruscev | 52 | II | Director and Chief Executive Officer | January 2008 |
| Harvey A. Wagner(1)(3) | 68 | III | Director | February 2005 |

(1) Current member of the Audit Committee.

(2) Current member of the Compensation Committee.

(3) Current member of the Governance Committee.

(4) Current member of the M&A Committee.

(5) Dr. Campbell previously served as a FormFactor Director from July 2003 through November 2004, when he resigned to serve as Director of Finance for the State of California.

*Dr. Homa Bahrami* has served as a Director since December 2004. Dr. Bahrami is a Senior Lecturer at the Haas School of Business, University of California at Berkeley. Dr. Bahrami has been on the Haas School faculty since 1986 and is widely published on organizational design and organizational

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development challenges and trends in the high technology sector. Dr. Bahrami currently serves on the board of directors of one privately held company. Dr. Bahrami holds a Ph.D. in organizational behavior from Aston University, United Kingdom.

*Dr. Thomas J. Campbell* has served as a Director since January 2006. Dr. Campbell previously served as a Director from July 2003 through November 2004, when he resigned to become the Director of Finance for the State of California. Dr. Campbell has served as a professor at the Haas School of Business since August 2002, and is currently on leave from the University of California at Berkeley to serve as Presidential Fellow and Distinguished Visiting Professor of Law at Chapman University in Orange, California. Dr. Campbell was the Dean of the Haas School of Business at the University of California at Berkeley from August 2002 to July 2008, taking a leave of absence from this post when he became California Director of Finance. Dr. Campbell was the California Director of Finance from December 2004 through November 2005. Dr. Campbell was a professor at Stanford Law School from 1983 to August 2002. Dr. Campbell served as a U.S. congressman from 1989 to 1993 and from 1995 to January 2001, and as a California state senator from 1993 to 1995. Dr. Campbell also served as Director of the Federal Trade Commission's Bureau of Competition from 1981 to 1983. Dr. Campbell serves on the board of directors of Visa Inc., a publicly traded company, where he is Chairman of the Governance Committee and a member of the Compensation Committee. Dr. Campbell holds a B.A., an M.A. and a Ph.D. in economics from the University of Chicago, and a J.D. from Harvard Law School.

*G. Carl Everett, Jr.* has served as a Director since June 2001. Mr. Everett founded GCE Ventures, a venture advisement firm, in April 2001. Mr. Everett has served as a partner at Accel LLP, a venture capital firm, since 2002. From February 1998 to April 2001, Mr. Everett served as Senior Vice President, Personal Systems Group of Dell Inc. During 1997, Mr. Everett was on a personal sabbatical. From 1978 to December 1996, Mr. Everett held several management positions with Intel Corporation, including Senior Vice President and General Manager of the Microprocessor Products Group, and Senior Vice President and General Manager of the Desktop Products Group. Mr. Everett currently serves on the board of directors of one privately held company. Mr. Everett holds a B.A. in business administration and a Doctorate of laws from New Mexico State University.

*Dr. Igor Y. Khandros* founded FormFactor in April 1993. Dr. Khandros has served as Executive Chairman of our Board of Directors since June 2008 and as a Director since our company's founding. Dr. Khandros served as our Chief Executive Officer from April 1993 to June 2008 when he became Chairman, and, because he remained an employee, he is the Executive Chairman of the Board. Dr. Khandros also served as our President from April 1993 to November 2004. From 1990 to 1992, Dr. Khandros served as the Vice President of Development of Tessera Technologies, Inc., a provider of chip scale packaging technology that he co-founded. From 1986 to 1990, he was employed at the Yorktown Research Center of IBM Corporation as a member of the technical staff and a manager. From 1979 to 1985, Dr. Khandros was employed at ABEX Corporation, a casting foundry and composite parts producer, as a research metallurgist and a manager, and he was an engineer from 1977 to 1978 at the Institute of Casting Research in Kiev, Ukraine. Dr. Khandros holds an M.S. equivalent degree in metallurgical engineering from Kiev Polytechnic Institute in Kiev, Ukraine, and a Ph.D. in metallurgy from Stevens Institute of Technology.

*Lothar Maier* has served as a Director since November 2006. Mr. Maier has served as the Chief Executive Officer and a member of the board of directors of Linear Technology Corporation, a supplier of high performance analog integrated circuits, since January 2005. Prior to that, Mr. Maier served as Linear Technology's Chief Operating Officer from April 1999 to December 2004. Before joining Linear Technology, Mr. Maier held various management positions at Cypress Semiconductor Corporation, a provider of high-performance, mixed-signal, programmable solutions, from 1983 to 1999, most recently as Senior Vice President and Executive Vice President of Worldwide Operations. Mr. Maier holds a B.S. in chemical engineering from the University of California at Berkeley.

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*James A. Prestridge* has served as a Director since April 2002, and since June 2008, has served as our Lead Independent Director. Mr. Prestridge served as Chairman of our Board of Directors from August 2005 to June 2008. Mr. Prestridge served as a consultant for Empirix Inc., a provider of test and monitoring solutions for communications applications, from October 2001 until October 2003. From June 1997 to January 2001, Mr. Prestridge served as a Director of five private companies that were amalgamated into Empirix. Mr. Prestridge served as a director of Teradyne, Inc., a manufacturer of automated test equipment, from 1992 until 2000. Mr. Prestridge was Vice-Chairman of Teradyne from January 1996 until May 2000 and served as Executive Vice President of Teradyne from 1992 until May 1997. Mr. Prestridge holds a B.S. in general engineering from the U.S. Naval Academy and an M.B.A. from Harvard University. Mr. Prestridge served as a Captain in the U.S. Marine Corps.

*Dr. Mario Ruscev* has served as our Chief Executive Officer since June 2008 and as a member of our Board of Directors since January 2008, when he joined our company. Dr. Ruscev previously served as our President from January 2008 to June 2008. Prior to joining FormFactor, Dr. Ruscev served as President of Testing Schlumberger Oilfield Services of Schlumberger Limited, a services company supplying technology, project management and information solutions for optimizing performance in the oil and gas industry, from April 2006 to December 2007. He also held several executive positions at Schlumberger during his 23 year career with that company, including President of Schlumberger Water and Carbon Services from April 2002 to March 2006, President of Wireline Schlumberger Oilfield Services from January 2001 to March 2002 and President of Geco-Prakla Schlumberger Oilfield Services from April 1999 to December 2000. Dr. Ruscev received a Doctorate in Nuclear Physics from Université, Pierre et Marie Curie in Paris, France and a Ph.D. in Nuclear Physics from Yale University.

*Harvey A. Wagner* has served as a Director since February 2005. Mr. Wagner joined Caregiver Services, Inc., a provider of in-home care services, as the President and Chief Executive Officer and a member of the board of directors in April 2008. Mr. Wagner founded the H.A. Wagner Group, LLC, a consulting firm, where he has served as managing principal since July 2007. Mr. Wagner previously served as President and Chief Executive Officer of Quovadx, Inc. (now Healthvision, Inc.), a software and services company, from October 2004 to July 2007, and as a member of the board of directors of Quovadx from April 2004 to July 2007. From May 2004 through October 2004, Mr. Wagner served as acting President and Chief Executive Officer of Quovadx. Prior to joining Quovadx, he served as Executive Vice President and Chief Financial Officer of Mirant Corporation, an independent energy company, from January 2003 through April 2004. Prior to joining Mirant, Mr. Wagner was Executive Vice President of Finance, Secretary, Treasurer, and Chief Financial Officer at Optio Software, Inc., a provider of business process improvement solutions, from February 2002 to December 2002. From May 2001 to January 2002, he performed independent consulting services for various corporations. He was Chief Financial Officer and Chief Operating Officer for PaySys International, Inc. from December 1999 to April 2001. Mr. Wagner also serves on the board of directors of Cree, Inc., a publicly traded company, where he is Chairman of the Audit Committee and a member of the Nominating and Governance Committee. Mr. Wagner serves on the board of directors of Startek, Inc., a publicly traded company, where he is Chairman of the Audit Committee, a member of the Governance Committee and a member of the Compensation Committee. Mr. Wagner holds a B.B.A. in accounting from the University of Miami.

**Emeritus Program**

Our Board of Directors established an Emeritus program in May 2005 under which our Board may appoint former directors to the position of Director Emeritus or Chairperson Emeritus in recognition of their service to our company and to assist in continuity of membership on our Board. Persons who accept appointment to the position of Director Emeritus or Chairperson Emeritus, as the case may be, provide advisory and consulting services on such business matters as our Board may determine and may participate in all meetings of our Board in a non-voting capacity. A Director Emeritus or Chairperson

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Emeritus serves for a one-year term that expires at the following annual meeting of our stockholders, which term is renewable. A Director Emeritus or Chairperson Emeritus is entitled to receive the same compensation for meetings actually attended as members of our Board of Directors, but they are not entitled to any equity awards, or any other fees or retainers. Dr. William H. Davidow, who served as a Director of FormFactor from April 1995 to August 2005, and as Chairman of the Board of Directors from June 1996 to August 2005, has served as Chairperson Emeritus since August 2005.

**Independence of Directors**

Our Board of Directors has determined that each of our directors, other than Dr. Khandros, our Executive Chairman of the Board of Directors, and Dr. Ruscev, our Chief Executive Officer, is independent. Accordingly, more than a majority of the members of our Board are independent. Our Board appointed Mr. Prestridge to serve as the Lead Independent Director in June 2008. We define "independent directors" pursuant to the rules of the U.S. Securities and Exchange Commission and the Nasdaq Global Market. To be considered independent, a director cannot be an officer or employee of our company or its subsidiaries, and cannot have a relationship with our company or its subsidiaries that, in the opinion of our Board, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director. Our Board consults with our company's legal counsel to ensure that its determinations are consistent with all relevant laws, rules and regulations regarding the definition of "independent director," including applicable securities laws and the rules of the U.S. Securities and Exchange Commission and Nasdaq Global Market.

**Board Meetings**

We set the dates and times of our Board of Directors and Board committee meetings in advance of each fiscal year. During our fiscal year 2008, our Board of Directors held six meetings, including two telephone conference meetings. During fiscal year 2008, all of the directors attended all of the meetings of the Board of Directors during the period that such director served, other than Ms. Bahrami and Mr. Everett who each attended all meetings but one, or 83.3% of such meetings.

The independent members of our Board of Directors meet regularly in executive sessions outside of the presence of management. The independent members met four times prior to regularly scheduled meetings of the Board of Directors during fiscal year 2008 in which all independent members attended.

**Committees of the Board of Directors**

Our Board of Directors has established four standing committees: the Audit Committee, the Compensation Committee, the Governance Committee and the M&A Committee. Members of each of the standing committees are set forth in the table above under "Board of Directors." Each committee has adopted a charter, which it reviews and assesses annually. Our Board of Directors has approved the charters of its committees. A copy of the charter of each committee is posted on our company's website at *www.formfactor.com*.

*Audit Committee.* The Audit Committee oversees our company's accounting and financial reporting processes and the audits of our financial statements, including oversight of our systems of internal controls and disclosure controls and procedures, compliance with legal and regulatory requirements, our internal audit function and the selection, compensation and evaluation of our independent registered public accounting firm. The members of our Audit Committee are currently and were in fiscal year 2008 Messrs. Everett, Prestridge and Wagner. Mr. Wagner is the chairperson of this committee and served as chairperson during fiscal year 2008. Our Board of Directors has determined that each member of the Audit Committee is independent within the meaning of the rules of the Securities and Exchange Commission and the Nasdaq Global Market, and is able to read and understand fundamental financial statements as contemplated by such rules. Our Board of Directors

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has also determined that Mr. Wagner is an audit committee financial expert within the meaning of the rules of the Securities and Exchange Commission and is financially sophisticated within the meaning of the rules of the Nasdaq Global Market. The Audit Committee met eleven times, including eight telephone conference meetings, during fiscal year 2008. During fiscal year 2008, all of the committee members attended all of the meetings of the Audit Committee during the period that such committee members served.

*Compensation Committee.* The Compensation Committee oversees our company's compensation and benefit plans, policies and programs, determines the compensation of our executive officers and executive chairman of the board of directors, and administers our equity and benefit plans. In addition, our Compensation Committee makes recommendations to the Board regarding appropriate compensation of our non-employee directors. The members of our Compensation Committee are currently and were in fiscal year 2008 Dr. Bahrami and Messrs. Everett, Maier and Prestridge. Mr. Prestridge is the chairperson of this committee and served as chairperson during fiscal year 2008. Our Board of Directors has determined that each member of the Compensation Committee is independent within the meaning of the rules of the Nasdaq Global Market, a non-employee director within the meaning of Section 16 of the Securities Exchange Act of 1934, and an outside director within the meaning of Section 162(m) of the Internal Revenue Code. The Compensation Committee met six times, including two telephone conference meetings, during fiscal year 2008. During fiscal year 2008, all of the committee members attended all of the meetings of the Compensation Committee during the period that such committee members served, other than Mr. Everett who attended all meetings but one, or 83.3% of such meetings.

*Governance Committee.* The Governance Committee oversees our company's corporate governance practices and our process for identifying, evaluating and recommending for nomination by our Board of Directors individuals for service on the Board and its committees. In addition, our Governance Committee assesses the composition and performance of our Board and our Board committees. The members of the Governance Committee are currently and were in fiscal year 2008 Dr. Bahrami and Messrs. Campbell and Wagner. Dr. Bahrami is the chairperson of this committee and served as chairperson during fiscal year 2008. Our Board of Directors has determined that each member of the Governance Committee is independent within the meaning of the rules of the Nasdaq Global Market and a non-employee director within the meaning of Section 16 of the Securities Exchange Act of 1934. The Governance Committee met five times, including one telephone conference meeting, during fiscal year 2008. During fiscal year 2008, all of the committee members attended all of the meetings of the Governance Committee during the period that such committee members served, other than Mr. Campbell who attended all meetings but two, or 60.0% of such meetings.

*M&A Committee.* The M&A Committee oversees the review and assessment of potential acquisitions, strategic investments, divestitures and joint ventures by our company. The members of the M&A Committee are currently Messrs. Everett, Maier and Prestridge. Mr. Everett is the chairperson of this committee. The members of the M&A Committee do, but are not required to, meet the independence requirements set forth in the Nasdaq Global Market rules. Our Board of Directors established the M&A Committee in February 2009. Accordingly, the M&A Committee did not meet in fiscal year 2008.

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**Director Compensation**

The form and amount of compensation paid to our independent directors for serving on our Board and its committees is designed to be competitive in light of industry practices and the obligations imposed by such service. In order to align the long-term interests of our directors with those of our stockholders, a portion of director compensation is provided in equity-based compensation. The value of total annualized compensation of our independent directors is targeted to be at approximately the median of our peer group of companies, which is described below under the "Compensation Discussion and Analysis" section in this Proxy Statement. The compensation practices of this peer group of companies were the benchmark used when considering the competitiveness of our independent director compensation in 2008. Our independent outside compensation consultant, Frederic W. Cook & Co., Inc., or FWC, and our company's Human Resources department collected and developed the competitive data and analyses for benchmarking independent director compensation. In May 2008, the Compensation Committee recommended and our Board approved changes to the initial and annual equity awards for new and re-elected independent directors and an additional annual cash retainer to our Board of Directors' Lead Independent Director.

The following table presents the compensation paid to our independent directors for fiscal year 2008. Dr. Khandros and Dr. Ruscev are not considered independent directors of our company because they are employees of our company. Compensation of Dr. Khandros and Dr. Ruscev is described under "Compensation Discussion and Analysis" and "Executive Compensation and Related Information" in this Proxy Statement.

| Name | Fees Earned or Paid in Cash ($) | Option Awards ($)(1)(2) | Stock Awards ($)(1)(2) | Total ($) |
|---|---|---|---|---|
| Dr. Homa Bahrami | 48,000 | 97,102 | 75,151 | 220,253 |
| Dr. Thomas J. Campbell | 36,000 | 97,102 | 75,151 | 208,253 |
| G. Carl Everett, Jr. | 48,000 | 176,817 | 36,549 | 261,367 |
| Lothar Maier | 39,000 | 51,155 | 75,151 | 165,306 |
| James A. Prestridge | 79,000 | 187,838 | 26,948 | 293,786 |
| Harvey A. Wagner | 58,000 | 97,102 | 75,151 | 230,253 |

(1) The stock awards are restricted stock units that we awarded to our independent directors under our 2002 Equity Incentive Plan. The restricted stock units will settle in shares of our common stock on the earlier of: (i) the date on which the units are fully vested, or (ii) the date that the director's engagement with our company is terminated (or the first market trading day during an open trading window under our company's Statement of Policy regarding Insider Trading thereafter if the applicable date is not on a market trading day during an open trading window). The price at which we will settle the restricted stock units is the closing price of our company's common stock on the Nasdaq Global Market on the trading date immediately prior to the settlement date.

The amounts shown reflect the dollar amount recognized for fiscal year 2008 financial statement reporting purposes in accordance with Financial Accounting Standards Board Statement of Financial Accounting Standards No. 123 (Revised), or FAS 123(R). For restricted stock units, fair value is calculated using the closing price on the grant date. The amounts shown disregard estimated forfeitures related to service-based vesting conditions. No restricted stock units were forfeited by any of our independent directors during fiscal year 2008. The grant date fair value of the restricted stock units granted on May 22, 2008 to each independent director re-elected on that date was $128,340. These amounts are different than the amounts in our company's consolidated financial statements in our Annual Report on Form 10-K for the fiscal year ended December 27, 2008 due to the estimated forfeitures reflected in the consolidated financial statements. These amounts do not correspond to the actual value that may be recognized by our independent

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directors. Assumptions used in the calculation of these amounts are described in Note 9 Stock-Based Compensation to our company's consolidated financial statements in our Annual Report on Form 10-K for the fiscal year ended December 27, 2008.

(2)

A summary of options and restricted stock units outstanding as of December 27, 2008 for each of our independent directors is as follows:

| Name | Stock Options Outstanding(#) | Restricted Stock Units Outstanding(#) |
|---|---|---|
| Dr. Homa Bahrami | 48,013 | 6,000 |
| Dr. Thomas J. Campbell | 15,000 | 6,000 |
| G. Carl Everett, Jr. | 55,000 | 6,000 |
| Lothar Maier | 22,726 | 6,000 |
| James A. Prestridge | 55,000 | 6,000 |
| Harvey A. Wagner | 40,410 | 6,000 |

*Cash Compensation.* The fiscal year 2008 cash compensation for our independent directors is set forth in the following table.

| Compensation Element | Fiscal Year 2008 Cash Compensation |
|---|---|
| Director Annual Retainer | $20,000 |
| Chairperson Annual Retainer | $25,000 for Board chairperson<br>$10,000 for Audit Committee chairperson<br>$5,000 for other committee chairperson |
| Board Meeting Fee | $2,000 per meeting, whether attended in person or telephonically |
| Committee Meeting Fee | $1,000 per meeting, whether attended in person or telephonically |

In August 2008, following Mr. Prestridge's appointment as the Lead Independent Director of our Board of Directors, the Compensation Committee approved an additional annual retainer of $25,000 to the Lead Independent Director.

*Equity Compensation.* Each of our independent directors is eligible to receive equity awards under our 2002 Equity Incentive Plan.

On May 22, 2008, the Compensation Committee approved the amendment of our 2002 Equity Incentive Plan to provide for new annual equity awards for new and re-elected independent directors. Instead of the automatic annual grant of 15,000 stock options to these directors, our 2002 Equity Incentive Plan now provides that each year our Board of Directors will determine whether independent directors receive stock options, restricted stock units or restricted stock, and in what amounts.

On May 22, 2008, our Board of Directors, upon recommendation of the Compensation Committee, approved modifications to the annual equity grant policy for new and re-elected independent directors. To better focus independent directors on the long-term performance of our company, our Board approved a change in the grant of equity from stock options to restricted stock units. Beginning with the 2008 annual meeting of stockholders, each new independent director will receive an initial award of 6,000 restricted stock units under the 2002 Equity Incentive Plan on the date the director joins our Board. Additionally, each re-elected independent director will receive an annual award of 6,000 restricted stock units under the 2002 Equity Incentive Plan immediately following the annual meeting of stockholders, which is subject to pro-ration if such director has not served as a director for the full 12 months since the preceding equity award to such director. The initial equity awards generally vest over a one-year period at a rate of 1/12th of the total shares granted at the end of each full succeeding

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month, subject to the director's continued service on our Board. All annual equity awards generally vest as to 1/12th of the total shares granted at the end of each full succeeding month from the later of the date of grant or the date when all outstanding equity awards and all outstanding shares issued upon exercise or conversion of any equity awards granted to the independent director prior to the grant of such succeeding award have fully vested. Restricted stock units will be settled in shares of our common stock upon the earlier of: (i) the date on which the restricted stock units are fully vested, or (ii) the director's termination date. If either the date on which the restricted stock units are fully vested or the director's termination date is not a NASDAQ Global Market trading day during an open trading window under our company's Statement of Policy Regarding Insider Trading as then in effect, then the restricted stock units will be settled on the first NASDAQ Global Market trading day falling within an open trading window thereafter. In the event of our dissolution or liquidation or a change in control transaction, all equity awards granted to our independent directors will become fully vested prior to the consummation of the transaction at such times and on such conditions as the Compensation Committee will determine, and any equity awards that are stock options will expire if the directors do not exercise the awards, as applicable, within three months of the consummation of the transaction.

Our independent directors may elect to receive a restricted stock award or restricted stock unit under our 2002 Equity Incentive Plan in lieu of payment of a portion of his or her annual retainer based on the fair market value of our common stock on the date any annual retainer would otherwise be paid. The annual retainer consists of the director or chairperson annual retainer plus any additional retainer paid in connection with service on any committee of our Board or paid for any other reason. A director may make an election for any dollar or percentage amount equal to at least 25% of his or her annual retainer up to a maximum of 100%. A director must make the election in accordance with Section 409A of the Internal Revenue Code of 1986, as amended. Any amount of the director's annual retainer that is not elected to be received as a restricted stock award or restricted stock unit is payable in cash. As of the date of this Proxy Statement, none of our independent directors have elected to receive a restricted stock award or restricted stock unit under our 2002 Equity Incentive Plan in lieu of payment of a portion of his or her annual retainer.

*Other.* We reimburse all of our directors for travel, director continuing education programs and other business expenses incurred in connection with their services as a member of our company's Board and Board committees, and extend coverage to them under our company's travel accident and directors' and officers' indemnity insurance policies.

**Compensation Committee Interlocks and Insider Participation**

None of the members of our Compensation Committee has at any time since our incorporation been one of our officers or employees. None of our executive officers serves or in the past has served as a member of the board of directors or compensation committee of any entity that has one or more of its executive officers serving on our Board of Directors or our Compensation Committee.

Our Compensation Committee engaged Frederic W. Cook & Co., Inc., an independent outside compensation consultant, to provide advice and recommendations on competitive market practices and specific compensation decisions. To date, this consultant has not provided our company's management with any services.

Our company has engaged independent consultants and other data collection services to assist our Human Resources department with collecting and analyzing information regarding the compensation practices of companies, including companies within our "core" peer group as described in "Compensation Discussion and Analysis" in this Proxy Statement. Some of these service providers have met with members of our company's management and the Compensation Committee. The service providers engaged by our company have not provided specific compensation recommendations or any other related advice or consulting services to the Compensation Committee.

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**Consideration of Director Nominees**

Our Governance Committee identifies, evaluates and recommends individuals for nomination by our Board of Directors for election as directors of our Board. The committee generally identifies nominees based upon recommendations by our directors and management. In addition, our Governance Committee also considers recommendations properly submitted by our stockholders. The committee may retain recruiting professionals to assist in the identification and evaluation of candidates for director nominees. To date, we have not paid any third parties to assist us in this process.

In selecting nominees for our Board of Directors, the Governance Committee considers candidates based on the need to satisfy the applicable rules and regulations of the Securities and Exchange Commission and the rules of the Nasdaq Global Market, including the requirements for independent directors and an audit committee financial expert. Our Governance Committee also evaluates candidates in accordance with its charter, assessing a number of factors, including demonstrated outstanding achievement in the prospective board member's personal career, breadth of experience, soundness of judgment, ability to make independent, analytical inquiries, diversity of viewpoints and experience, and willingness to devote adequate time. The Governance Committee uses the same standards to evaluate nominees proposed by our directors, management and stockholders.

Stockholders can recommend qualified candidates for our Board of Directors by writing to our Corporate Secretary at FormFactor, Inc., 7005 Southfront Road, Livermore, California 94551. When making recommendations, a stockholder must submit recommendations for individuals that meet at least the criteria outlined above. Such recommendations should be accompanied by the information required by our bylaws and Regulation 14A under the Securities Exchange Act of 1934, as amended, which includes evidence of the nominating stockholder's ownership of FormFactor common stock, biographical information regarding the candidate, and the candidate's written consent to serve as a director if elected. We require that any such recommendations for inclusion in our proxy materials for our 2010 Annual Meeting of Stockholders be made no later than December 9, 2009 to ensure adequate time for meaningful consideration by our Governance Committee. See "Proposals for the 2010 Annual Meeting of Stockholders" for additional information regarding deadlines for submitting proposals. Properly submitted recommendations will be forwarded to our Governance Committee for review and consideration. The Governance Committee may consider in the future whether our company should adopt a more formal policy regarding stockholder nominations.

After evaluating Messrs. Prestridge and Wagner, our Governance Committee recommended to our Board of Directors in accordance with its charter, and our Board approved, the nomination of these current directors for election as Class III members to our Board at our Annual Meeting.

**Corporate Codes**

We have adopted a Statement of Corporate Code of Business Conduct that applies to our directors, officers and employees, and a Statement of Financial Code of Ethics that applies to our Chief Executive Officer, Chief Financial Officer and the employees in our finance department. Our directors, officers and employees are also subject to our Statement of Policy Regarding Insider Trading and our Statement of Policy Regarding Related Person Transactions. We provide training to our employees regarding our codes and various company policies, which all employees are required to complete. In addition, we have adopted a Statement of Policy Regarding Corporate Code Violations (Complaints and Concerns and Whistleblowers) that is designed to ensure that all of our directors, officers and employees observe high standards of personal and business ethics consistent with the Code of Business Conduct, the Code of Ethics and our other company policies, and to provide a forum to which our directors, officers and employees may report violations or suspected violations of our company policies without fear of harassment, retaliation or adverse employment consequences. In addition, we have adopted Governance Guidelines, which identify various corporate policies and

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practices we have implemented. Our policies and governance guidelines are posted on our website at *www.formfactor.com*.

**Stockholder Communications with our Board**

Our stockholders may communicate with our Board of Directors or any of our individual directors by submitting correspondence by mail to our Corporate Secretary at FormFactor, Inc., 7005 Southfront Road, Livermore, California 94551, or by e-mail at corporatesecretary@formfactor.com. Our Corporate Secretary or his designee will review such correspondence and provide such correspondence and/or summaries thereof, as appropriate, to our Board of Directors. Our company's acceptance and forwarding of communications to our Board does not imply that the company's directors owe or assume any fiduciary duties to persons submitting the communications. Our Corporate Secretary or his designee will handle correspondence relating to accounting, internal controls or auditing matters in accordance with our Statement of Policy Regarding Corporate Code Violations (Complaints and Concerns and Whistleblowers), which Statement is available on our company's website at *www.formfactor.com*. Our Governance Committee will periodically review our process for stockholders to communicate with our Board of Directors to ensure effective communications.

**Board Attendance at Annual Meetings**

We encourage the members of our Board of Directors to attend our annual meeting of stockholders. We do not have a formal policy regarding attendance of annual meetings by the members of our Board. We may consider in the future whether our company should adopt a more formal policy regarding director attendance at annual meetings. All of our directors serving at the time of our 2008 Annual Meeting of Stockholders attended that annual meeting.

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**PROPOSAL NO. 2**

**RATIFICATION OF SELECTION OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM FOR FISCAL YEAR 2009**

The second proposal is to ratify the selection of PricewaterhouseCoopers LLP as FormFactor's independent registered public accounting firm for fiscal year 2009. The Audit Committee of our Board of Directors has appointed PricewaterhouseCoopers LLP as the independent registered public accounting firm to perform the audit of our financial statements for fiscal year 2009, and our stockholders are being asked to ratify such selection. Representatives of PricewaterhouseCoopers LLP are expected to be present at the Annual Meeting, will have the opportunity to make a statement at the Annual Meeting if they desire to do so and are expected to be available to respond to appropriate questions.

Ratification by our stockholders of the selection of PricewaterhouseCoopers LLP as our independent registered public accounting firm is not required by applicable law, our certificate of incorporation, our bylaws or otherwise. However, our Board of Directors is submitting the selection of PricewaterhouseCoopers LLP to our stockholders for ratification as a matter of good corporate practice. If our stockholders fail to ratify this selection, our Audit Committee will reconsider whether to retain that firm. Even if the selection is ratified, our Audit Committee in its discretion may direct the selection of a different independent registered public accounting firm at any time during the year if it determines that such a change would be in the best interests of our company and stockholders.

**Our Board of Directors recommends a vote FOR the ratification of the selection of PricewaterhouseCoopers LLP as our independent registered public accounting firm for fiscal year 2009.**

**Principal Auditor Fees and Services**

The following is a summary of fees for professional services rendered to our company by PricewaterhouseCoopers LLP, our independent registered public accounting firm, related to fiscal year 2008 and 2007.

| | 2008 | 2007 |
|---|---|---|
| Audit Fees | $1,167,792 | $1,301,220 |
| Audit-Related Fees | | |
| Tax Fees | 188,897 | 43,478 |
| All Other Fees | | |
| Total | $1,356,689 | $1,344,698 |

*Audit Fees.* Consists of fees billed for professional services rendered for the audit of our annual consolidated financial statements, the audit of the effectiveness of our internal control over financial reporting, and the review of our consolidated financial statements included in our Form10-Q quarterly reports for fiscal year 2008 and 2007. For fiscal year 2007, the fees also include services in connection with the restatement of our annual and interim financial statements for fiscal year 2006 and interim financial statements for the first and second quarters of fiscal year 2007. Audit fees also include services that are normally provided by the independent registered public accounting firm in connection with statutory and regulatory filings or engagements for those fiscal years.

*Audit-Related Fees.* Consists of fees billed for assurance and related services that are traditionally performed by the independent registered public accountant and are not reported under "Audit Fees."

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*Tax Fees.* Consists of fees billed for professional services for tax compliance, tax preparation, tax advice and tax planning. These services consist of assistance regarding federal, state and international tax compliance, assistance with the preparation of various tax returns, research and design tax study and international compliance.

*All Other Fees.* Consists of fees for products and services other than the services reported above.

**Pre-Approval of Audit and Non-Audit Services of Auditor**

Our Audit Committee's policy is to pre-approve all audit and permissible non-audit services provided by our independent registered public accounting firm. These services may include audit services, audit-related services, tax services and other services. Pre-approval is generally provided for up to one year and any pre-approval is detailed as to the particular service or category of services and is generally subject to a specific budget. Our independent registered public accounting firm and management are required to periodically report to our Audit Committee regarding the extent of services provided by our independent registered public accounting firm in accordance with this pre-approval, and the fees for the services performed to date. Our Audit Committee may also pre-approve particular services on a case-by-case basis. All of the services described above with respect to audit fees and tax fees were pre-approved by our Audit Committee pursuant to its pre-approval policy.

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## SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

**Beneficial Ownership of our Securities**

The following table presents information regarding the beneficial ownership of our common stock as of February 28, 2009 for:

- each person or entity known by us to own beneficially more than 5% of our common stock;
- each of our directors;
- our Chief Executive Officer and the other current and former executive officers named in the summary compensation table under "Executive Compensation and Related Information;" and
- all of our directors and such officers as a group.

The percentage of beneficial ownership for the following table is based on 49,299,032 shares of our common stock outstanding as of February 28, 2009. Beneficial ownership is determined under the rules and regulations of the Securities and Exchange Commission and does not necessarily indicate beneficial ownership for any other purpose. Under these rules, beneficial ownership includes those shares of common stock over which the stockholder has sole or shared voting or investment power. It also includes shares of common stock that the stockholder has a right to acquire within 60 days of February 28, 2009 through the exercise of any option, unit or other right. The percentage ownership of the outstanding common stock, however, is based on the assumption, expressly required by the rules and regulations of the Securities and Exchange Commission, that only the person or entity whose ownership is being reported has exercised options, units or other rights into shares of our common stock.

To our knowledge, except under community property laws or as otherwise noted, the persons named in the table below have sole voting and sole investment power with respect to all equity beneficially owned. Unless otherwise indicated, each director, officer and 5% stockholder listed below

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maintains a mailing address of c/o FormFactor, Inc., 7005 Southfront Road, Livermore, California 94551.

| Beneficial Owner | Number of Shares Beneficially Owned | Percentage of Shares Beneficially Owned |
|---|---|---|
| PRIMECAP Management Company(1) | 7,126,600 | 14.5% |
| Vanguard Horizon Funds Vanguard Capital Opportunity Fund(2) | 5,983,300 | 12.1 |
| FMR LLC and affiliated persons(3) | 5,386,622 | 10.9 |
| Franklin Resources, Inc. and affiliated persons(4) | 4,654,541 | 9.4 |
| Goldman Sachs Asset Management, L.P. and affiliated persons(5) | 3,009,465 | 6.1 |
| Dr. Igor Y. Khandros(6) | 2,817,497 | 5.7 |
| T. Rowe Price Associates, Inc.(7) | 2,747,000 | 5.6 |
| Kornitzer Capital Management, Inc.(8) | 2,529,285 | 5.1 |
| Stuart L. Merkadeau(9) | 277,640 | * |
| Richard M. Freeman(10) | 240,080 | * |
| Dr. Mario Ruscev(11) | 37,455 | * |
| Jean B. Vernet(12) | 18,239 | * |
| Ronald C. Foster(13) | 145,122 | * |
| Jorge L. Titinger(14) | | |
| James A. Prestridge (15) | 104,748 | * |
| G. Carl Everett, Jr.(16) | 77,118 | * |
| Dr. Homa Bahrami(17) | 51,013 | * |
| Harvey A. Wagner(18) | 40,410 | * |
| Lothar Maier(19) | 22,726 | * |
| Dr. Thomas J. Campbell(20) | 15,000 | * |
| All directors and officers as a group (13 persons) | 3,847,048 | 7.6% |

* Represents beneficial ownership of less than 1%.

(1) As reported in the Schedule 13G/A of PRIMECAP Management Company for beneficial ownership as of December 31, 2008, which was filed on February 12, 2009 with the Securities and Exchange Commission. The address of PRIMECAP Management Company is 225 South Lake Avenue, #400, Pasadena, California 91101.

(2) As reported in the Schedule 13G/A of Vanguard Horizon Funds Vanguard Capital Opportunity Fund for beneficial ownership as of December 31, 2008, which was filed on February 13, 2009 with the Securities and Exchange Commission. The address of Vanguard Horizon Funds Vanguard Capital Opportunity Fund is 100 Vanguard Boulevard, Malvern, Pennsylvania 19355.

(3) As reported in the Schedule 13G/A of FMR LLC and affiliated persons for beneficial ownership as of December 31, 2008, which was filed on February 17, 2009 with the Securities and Exchange Commission. The address of FMR LLC and related persons is 82 Devonshire Street, Boston, Massachusetts 02109.

(4) As reported in the Schedule 13G/A of Franklin Resources, Inc. and affiliated persons for beneficial ownership as of December 31, 2008, which was filed on February 6, 2009 with the Securities and Exchange Commission. The address of Franklin Resources, Inc. and related persons is One Franklin Parkway, San Mateo, California 94403.

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(5) As reported in the Schedule 13G/A of Goldman Sachs Asset Management, L.P. and affiliated persons for beneficial ownership as of December 31, 2008, which was filed on February 5, 2009 with the Securities and Exchange Commission. The address of Goldman Sachs Asset Management, L.P. is 32 Old Slip, New York, New York 10005.

(6) Represents 2,309,499 shares held by The Khandros Bloch Revocable Trust and 507,998 shares issuable upon exercise of options that are exercisable within 60 days of February 28, 2009, all of which shares will be vested.

(7) As reported in the Schedule 13G of T. Rowe Price Associates, Inc. for beneficial ownership as of December 31, 2008, which was filed on February 10, 2009 with the Securities and Exchange Commission. The address of T. Rowe Price Associates, Inc. is 100 East Pratt Street, Baltimore, Maryland 21202.

(8) As reported in the Schedule 13G of Kornitzer Capital Management, Inc. for beneficial ownership as of December 31, 2008, which was filed on January 9, 2009 with the Securities and Exchange Commission. The address of Kornitzer Capital Management, Inc. is 5420 West 61st Place, Shawnee Mission, Kansas 66205.

(9) Represents 10,221 shares held by the Stuart L. Merkadeau and Lisa A. Merkadeau Living Trust, 2,386 shares held directly by Mr. Merkadeau and 265,033 shares issuable upon exercise of options that are exercisable within 60 days of February 28, 2009, all of which shares will be vested.

(10) Represents 240,080 shares issuable upon exercise of options that are exercisable within 60 days of February 28, 2009, all of which shares will be vested.

(11) Represents 6,205 shares held directly by Dr. Ruscev and 31,250 shares issuable upon exercise of options that are exercisable within 60 days of February 28, 2009, all of which shares will be vested.

(12) Represents 739 shares held directly by Mr. Vernet, 12,500 shares issuable upon exercise of options that are exercisable within 60 days of February 28, 2009, all of which shares will be vested, and 5,000 shares issuable upon conversion of restricted stock units that will be settled within 60 days of February 28, 2009, all of which shares will be vested.

(13) Represents 145,122 vested shares issuable upon exercise of options that are exercisable until September 21, 2009 pursuant to the Separation Agreement and General Release entered into by our company with Mr. Foster, who resigned as Senior Vice President, Chief Financial Officer of our company effective as of March 21, 2008. Additional information regarding his holdings of FormFactor securities is not available to our company.

(14) Mr. Titinger resigned as Senior Vice President, Product Business Group of our company effective as of June 7, 2008. Information regarding his holdings of FormFactor securities is not available to our company.

(15) Represents 49,748 shares held by the Prestridge Family Trust, and 55,000 shares issuable upon exercise of options that are exercisable within 60 days of February 28, 2009, of which 40,000 shares will be vested and 15,000 shares will be unvested.

(16) Represents 22,118 shares held by the Everett Family Revocable Trust, and 55,000 shares issuable upon exercise of options that are exercisable within 60 days of February 28, 2009, of which 51,250 shares will be vested and 3,750 shares will be unvested.

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(17) Represents 3,000 shares held directly by Dr. Bahrami and 48,013 shares issuable upon exercise of options that are exercisable within 60 days of February 28, 2009, all of which shares will be vested.

(18) Represents 40,410 shares issuable upon exercise of options that are exercisable within 60 days of February 28, 2009, all of which shares will be vested.

(19) Represents 22,726 shares issuable upon exercise of options that are exercisable within 60 days of February 28, 2009, all of which shares will be vested.

(20) Represents 15,000 shares issuable upon exercise of options that are exercisable within 60 days of February 28, 2009, all of which shares will be vested.

**Equity Compensation Plans**

The following table sets forth certain information, as of December 27, 2008, concerning securities authorized for issuance under all equity compensation plans of our company:

| Plan Category | Number of Securities to be issued upon exercise of outstanding options, warrants and rights (a) | Weighted-average price of outstanding options, warrants and rights (b) | Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column(a)) (c) |
|---|---|---|---|
| Equity Compensation plans approved by our stockholders(1)(2) | 7,270,685(3) | $ 27.36(4) | 8,870,550(5) |
| Equity compensation plans not approved by our stockholders | | | |
| Total: | 7,270,685 | $ 27.36 | 8,870,550 |

(1) Includes our 2002 Equity Incentive Plan, 2002 Employee Stock Purchase Plan, Incentive Option Plan and Management Incentive Option Plan. Since the effectiveness of our 2002 Equity Incentive Plan in connection with our initial public offering, we do not grant any options under our Incentive Option Plan and Management Incentive Option Plan.

(2) Our 2002 Equity Incentive Plan and our 2002 Employee Stock Purchase Plan provide that on each January 1st, the number of shares available for issuance under such plans shall increase by an amount equal to 5% of our total outstanding shares as of December 31st of the prior year for the Equity Incentive Plan and 1% of our total outstanding shares as of December 31st of the prior year for the Employee Stock Purchase Plan.

(3) Includes 583,865 shares subject to outstanding restricted stock units. Excludes securities that may be issued under our 2002 Employee Stock Purchase Plan.

(4) Excludes outstanding restricted stock units, which do not have an exercise price.

(5) Includes 2,291,804 shares of our common stock remaining reserved for future issuance under our 2002 Employee Stock Purchase Plan as of December 27, 2008.

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**REPORT OF THE AUDIT COMMITTEE**

The Audit Committee oversees FormFactor's accounting and financial reporting processes on behalf of our Board of Directors. FormFactor's management has primary responsibility for the preparation and integrity of our company's consolidated financial statements, for implementing systems of internal control over financial reporting and for other financial reporting-related functions. The company's independent registered public accounting firm, PricewaterhouseCoopers LLP, is responsible for performing an independent audit of FormFactor's consolidated financial statements, expressing an opinion, based upon its audit, as to the conformity of such financial statements with generally accepted accounting principles in the United States and attesting to the effectiveness of FormFactor's internal control over financial reporting.

In discharging its oversight responsibility, the Audit Committee has reviewed and discussed, with our management and PricewaterhouseCoopers LLP, the audited consolidated financial statements of FormFactor as of and for the year ended December 27, 2008, including a discussion of the quality of FormFactor's financial reporting and internal control over financial reporting, as well as the selection, application and disclosure of critical accounting policies. In addition, the Audit Committee has reviewed and discussed the reports of FormFactor's internal audit function and the performance of the internal audit function during fiscal year 2008.

The Audit Committee has discussed with PricewaterhouseCoopers LLP, with and without the company's management present, the matters required to be discussed by Statement on Auditing Standards No. 114, "The Auditor's Communication With Those Charged With Governance," which supersedes Statement on Auditing Standards No. 61 as amended, "Communication with Audit Committees," including the judgment of PricewaterhouseCoopers LLP as to the quality of our company's financial reporting, effectiveness of internal control over financial reporting and such other matters as are required to be discussed with the Audit Committee under generally accepted auditing standards. The Audit Committee also discussed with PricewaterhouseCoopers LLP the remediated material weakness regarding the failure to maintain effective controls over the valuation of inventory and the related cost of revenues accounts, which was previously identified in our company's internal control over financial reporting, and the remediation steps our company's management took to address the material weakness.

The Audit Committee has received and reviewed the written disclosures and the letter from PricewaterhouseCoopers LLP required by the applicable requirements of the Public Company Accounting Oversight Board regarding the independent accountant's communications with the audit committee concerning independence, and has discussed with PricewaterhouseCoopers LLP the independent accountant's independence.

Based on the above-mentioned reviews and discussions, the Audit Committee has recommended to our Board of Directors that FormFactor's consolidated financial statements as of and for the year ended December 27, 2008 be included in the company's Annual Report on Form 10-K for the year ended December 27, 2008.

Submitted by the Audit Committee

Harvey A. Wagner, Chairperson
G. Carl Everett, Jr.
James A. Prestridge

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## COMPENSATION DISCUSSION AND ANALYSIS

This compensation discussion and analysis describes and analyzes FormFactor's compensation program for its named executive officers, namely, each of the two individuals who served as our Chief Executive Officer during fiscal year 2008, each of the two individuals who served as our Chief Financial Officer during fiscal year 2008, and the three most highly compensated executive officers (other than the Chief Executive Officer and the Chief Financial Officer) in fiscal year 2008. In June 2008, Dr. Mario Ruscev succeeded Dr. Igor Y. Khandros as Chief Executive Officer of our company, and Dr. Khandros was appointed Executive Chairman of the Board of Directors. In March 2008, Jean B. Vernet succeeded Ronald C. Foster as Senior Vice President, Chief Financial Officer. Therefore, in fiscal year 2008, we had seven named executive officers.

### Compensation Philosophy and Framework

*Compensation Objectives*

We are committed to a compensation philosophy that is market-competitive and ensures that our executive officers and other employees share in our company's success. Our executive compensation plans, policies and programs are overseen by the Compensation Committee of our Board of Directors and are designed to achieve three primary objectives:

Attract, retain and motivate highly skilled individuals who contribute to the success of our company, and that of our stockholders,

Drive outstanding achievement of business objectives and reinforce our company's strong pay-for-performance culture, and

Align our executive officers' interests and value creation opportunities with the long-term interests and value creation opportunities of our stockholders.

*Target Pay Position/Mix of Pay*

Our compensation program is comprised of a combination of base salary, semi-annual pay-for-performance cash incentive payments, and long-term equity grants. Each of these components is discussed in greater detail below under "Compensation Decisions." We target our pay, both for the individual components and in the aggregate, to be competitive with the practices of our peer companies. Our strategy has been to examine peer group compensation practices, and with an understanding of those practices, create a highly leveraged, variable compensation opportunity for our executive officers. The Compensation Committee believes this approach best supports the pay-for-performance culture, and in turn, the creation of stockholder value. Our emphasis on variable, or at-risk, compensation ensures that our executive officers receive target or above-target compensation only to the extent that our company's performance goals have been achieved or exceeded.

The Compensation Committee has historically approved actual compensation levels for executive officers above and below the target pay position, based on individual and company performance, to ensure an appropriate pay-for-performance alignment.

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*Compensation Benchmarking*

The Compensation Committee examines annually the compensation practices of a peer group of companies to assess the competitiveness of all elements of our executive officer compensation programs. In late 2007, with the assistance of FWC, we developed a "core" peer group of 19 companies that are comparable to our company based on the objective selection criteria in the table below and Global Industry Classification Standard codes. The compensation practices of this peer group of companies were the primary benchmark used when considering the competitiveness of our executive officer compensation in 2008. Additionally, we examined the compensation practices of 11 larger companies with which our company competes directly for key executive talent.

| | Industry Sector (Global Industry Classification Standard Code) | Last Completed Fiscal Year Revenue | | Market Capitalization as of November 2007 | | Employee Size as of Last Completed Fiscal Year-End | |
|---|---|---|---|---|---|---|---|
| | | Range | Median | Range | Median | Range | Median |
| "Core" Peer Group | Semiconductor (45301020)/ Semiconductor equipment (45301010) | $200 million-$1.5 billion | $850 million | $750 million-$6 billion | $3.4 billion | 400-3,000 | 1,700 |
| FormFactor | Semiconductor equipment (45301010) | | $462 million | | $1.6 billion | | 1,124 |

The companies that are part of our "core" peer group for 2008 include:

| | | |
|---|---|---|
| ATMI, Inc. | Integrated Device Technology, Inc. | Silicon Laboratories Inc. Teradyne, Inc. |
| Brooks Automation, Inc. | Intersil Corporation | Tessera Technologies, Inc. |
| Cabot Microelectronics Corporation | Lam Research Corporation | Varian Semiconductor Equipment Associates, Inc. |
| Cree, Inc. | MicroSemi Corporation | Verigy Ltd. |
| Cymer, Inc. | MKS Instruments, Inc. | |
| Fairchild Semiconductor International, Inc. | Novellus Systems, Inc. | |
| FEI Company | OmniVision Technologies, Inc. | |

In December 2008, the Compensation Committee, again with the assistance of FWC, completed its annual review of our peer group. Based on the Compensation Committee's review and advice of FWC, our updated "core" peer group consists of 22 companies for purposes of determining the competitiveness of our executive officer compensation in 2009. Similar to the "core" peer group used in 2008, the 2009 peer companies were selected using the Global Industry Classification Standard codes and the objective criteria shown in the table below.

| | Industry Sector (Global Industry Classification Standard Code) | Last Completed Fiscal Year Revenue | | Market Capitalization as of December 31, 2008 | | Employee Size as of Last Completed Fiscal Year-End | |
|---|---|---|---|---|---|---|---|
| | | Range | Median | Range | Median | Range | Median |
| "Core" Peer Group | Semiconductor (45301020)/ Semiconductor equipment (45301010) | $200 million-$1.9 billion | $554 million | $100 million-$2.7 billion | $675 million | 381-9,691 | 1,650 |
| FormFactor | Semiconductor equipment (45301010) | | $210 million | | $716 million | | 940 |

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The companies that are part of our "core" peer group for 2009 include:

| | | |
|---|---|---|
| ATMI, Inc. | FEI Company | Semitool, Inc.* |
| Brooks Automation, Inc. | Integrated Device Technology, Inc. | Silicon Laboratories Inc. |
| Cabot Microelectronics Corporation | Intersil Corporation | Teradyne, Inc. |
| Cohu, Inc.* | Lam Research Corporation | Tessera Technologies, Inc. |
| Cree, Inc. | MicroSemi Corporation | Varian Semiconductor Equipment Associates, Inc. |
| Cymer, Inc. | MKS Instruments, Inc. | Verigy Ltd. |
| Emcore Corporation* | Novellus Systems, Inc. | |
| Fairchild Semiconductor International, Inc. | OmniVision Technologies, Inc. | |

* New additions for 2009.

The Compensation Committee also reviews, on at least an annual basis, and makes recommendations, if necessary, to our Board of Directors for approval regarding compensation of the independent directors. The form and amount of compensation paid to our independent directors for serving on our Board and its committees is designed to be competitive in light of industry practices and the obligations imposed by such service. In order to align the long-term interests of our directors with those of our stockholders, a portion of director compensation is provided in equity-based compensation. The value of total annualized compensation of our independent directors is targeted to be at approximately the median of our peer group. The compensation practices of this peer group of companies were the benchmark used when considering the competitiveness of our independent director compensation in 2008. FWC and our company's Human Resources department collected and developed the competitive data and analyses for benchmarking independent director compensation. In May 2008, the Compensation Committee recommended and our Board approved changes to the initial and annual equity awards for new and re-elected independent directors and an additional annual cash retainer to our Board of Directors' Lead Independent Director. For a complete discussion of these changes and all compensation paid to independent directors in fiscal year 2008, please refer to the "Proposal No. 1 Election of Class III Directors Director Compensation" section above in this Proxy Statement.

**Compensation Decisions**

The Compensation Committee retains and does not delegate any of its exclusive power to determine all matters of executive compensation and benefits, although our Chief Executive Officer and the company's Human Resources department periodically present compensation and benefit recommendations to the Compensation Committee. FWC works directly with the Compensation Committee, and not on behalf of our company's management, to provide advice and recommendations on competitive market practices and specific compensation decisions. To date, FWC has not provided our company's management with any services.

**Compensation Components**

*Base Salary*

Base salaries are designed to provide market-competitive, fixed compensation, which allows us to attract and retain the highly skilled executive officers required to drive business results and stockholder value.

The Compensation Committee typically reviews base salary rates for our executive officers annually. Salary rates and any annual adjustments are determined by the Committee based on a number of factors, including level of responsibility, expertise, and experience of the individual, internal equity, individual and company performance, competitive conditions in the industry, and salary norms for individuals in comparable positions at comparable companies. Base salaries are targeted to be at

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approximately the median of our peer group. The Committee also considers recommendations made by our Chief Executive Officer regarding salary rate adjustments for his direct reports. Discussions regarding the compensation of each executive officer, including our Chief Executive Officer, are held outside of his presence.

In fiscal year 2008, the Compensation Committee set the base salary level of our Chief Executive Officer, who in turn recommended for approval by the Compensation Committee the base salary levels of our company's other officers who reported to the Chief Executive Officer.

*2008 Base Salary.* Dr. Khandros' base salary was decreased from $500,000 to $400,000 in connection with his appointment as Executive Chairman of the Board of Directors and his corresponding reduced role. Dr. Ruscev's base salary remained at $500,000 when he was promoted from President to Chief Executive Officer. In determining Dr. Ruscev's 2008 base salary, the Compensation Committee discussed his performance and reviewed competitive data and analyses collected and developed by FWC and our company's Human Resources department. The Compensation Committee maintained Dr. Ruscev's salary at $500,000 (the same as it was for Dr. Khandros when he was Chief Executive Officer), which approximates the 50$^{th}$ percentile of our 2008 peer group.

In May 2008, Dr. Khandros presented his base salary recommendations for the officers that reported to him, including the officers named in the summary compensation table under "Executive Compensation and Related Information" to the Compensation Committee. The Compensation Committee then discussed Dr. Khandros' recommendations and, based on the competitive data and analyses collected and developed by FWC and our company's Human Resources department, approved a merit-based base salary increase for Mr. Merkadeau as noted below effective June 30, 2008. Mr. Merkadeau's new base salary is slightly above the 50$^{th}$ percentile for the same position within our peer group. The Committee did not change the base salary of Mr. Vernet, who joined our company on March 31, 2008. Mr. Vernet's base salary is at approximately the 50$^{th}$ percentile for the same position within our peer group.

The base salaries for our executive officers in fiscal year 2008 were as follows:

| Executive Officer | Position | Base Salary | Percentage Increase (Decrease) |
|---|---|---|---|
| Dr. Igor Y. Khandros(1) | Executive Chairman of the Board of Directors and former Chief Executive Officer | $400,000 | (20.0)% |
| Dr. Mario Ruscev(2) | Chief Executive Officer and former President | 500,000 | |
| Jean B. Vernet(3) | Senior Vice President, Chief Financial Officer | 325,000 | |
| Richard M. Freeman(4) | Senior Vice President, Operations | 330,000 | 0.0 |
| Stuart L. Merkadeau | Senior Vice President, General Counsel and Secretary | 280,000 | 7.7 |
| Ronald C. Foster(5) | Former Senior Vice President, Chief Financial Officer | | |
| Jorge L. Titinger(6) | Former Senior Vice President, Product Business Group | | |

(1) Dr. Khandros served as Chief Executive Officer of our company until he was appointed Executive Chairman of the Board of Directors effective June 28, 2008, at which point he reduced his work schedule to four days per week, with a proportionate reduction in base salary.

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(2) Dr. Ruscev joined our company on January 7, 2008 as President. Effective June 28, 2008, we promoted him to Chief Executive Officer.

(3) Mr. Vernet joined our company on March 31, 2008 as Senior Vice President, Chief Financial Officer.

(4) Mr. Freeman has served as our company's Senior Vice President, Manufacturing since January 2009. Mr. Freeman was as our Senior Vice President, Operations from September 2004 to December 2008.

(5) Mr. Foster, our former Senior Vice President, Chief Financial Officer, resigned from our company effective as of March 21, 2008.

(6) We mutually agreed with Mr. Titinger, our former Senior Vice President, Product Business Group, to eliminate his position as part of our company's restructuring that we announced in our first fiscal quarter of 2008. Mr. Titinger's last day of employment was June 7, 2008.

In March 2009, Dr. Khandros requested, and the Compensation Committee approved, a 25% decrease in his annual base salary from $400,000 to $300,000 effective March 23, 2009 coinciding with a proportionate reduction in his work schedule to three days per week.

*Bonus*

We provide a semi-annual bonus opportunity through our company's Employee Incentive Plan (known as the Key Employee Bonus Plan prior to August 2008 when the Plan was expanded to include most of our professional employees worldwide), which awards cash bonuses to our Chief Executive Officer, other executive officers and other employees based upon the achievement of corporate and individual performance objectives. For the last several years, including fiscal year 2008, bonus target levels were established so that target total cash compensation was at the 75$^{th}$ percentile for comparable positions in our company's peer group. We set these levels to adequately reward our executive officers if our company meets or exceeds its corporate performance objectives.

The Compensation Committee, working with our management, approves corporate performance objectives for each half of the fiscal year for our Employee Incentive Plan. These corporate performance objectives are set at challenging levels to motivate high business performance and support attainment of company-critical financial and operational objectives. The Compensation Committee also approves a specific weighting for each objective.

For fiscal year 2008, Dr. Khandros worked with the officers who directly reported to him to identify and set individual performance objectives. Individual performance is generally based on a review of the individual's accomplishment towards specific agreed operational objectives and in the areas of leadership, management, overall performance and development. For fiscal year 2008, the Compensation Committee based the bonus payout for Dr. Khandros only on achievement of corporate performance objectives, because the Committee believes that Dr. Khandros should be rewarded for management of our company as measured by achievement of the corporate performance objectives, and in effect, the extent to which our company's performance enhances stockholder value. The Compensation Committee applied a very similar belief and approach to the bonus payout for Dr. Ruscev, though it was recognized that for fiscal 2008 Dr. Ruscev's bonus payout was contractually guaranteed. For our other executive officers, the Committee weighted individual performance objectives at 20% of the bonus. For a bonus to be awarded, an officer must meet his/her minimum individual performance objectives. In addition, an officer's actual achievement of individual performance objectives is used to adjust the achievement of corporate performance objectives when calculating the officer's bonus as set forth in the formula below, by multiplying the percent achievement of corporate objectives by the percent achievement of personal objectives.

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During the first half of fiscal year 2008, the corporate performance objectives were bookings, revenue, non-GAAP operating income and new product revenue. We derive non-GAAP operating income by subtracting stock-based compensation expense under FAS123 (R) from our company's operating income calculated in accordance with generally accepted accounting principles in the United States, or GAAP. Each corporate performance objective was weighted at 15%, except non-GAAP operating income was weighted at 55%. In addition, the Committee conditioned any payment for the first half of fiscal year 2008 upon our company achieving at a minimum the internal targets of $175 million in revenue and $8 million in non-GAAP operating loss. The Compensation Committee weighted the corporate performance objectives for Drs. Khandros and Ruscev at 100%. For our other executive officers, the Committee weighted the corporate objectives at 80%, with the remaining 20% consisting of individual performance objectives as discussed above.

For the first half of fiscal year 2008, the Compensation Committee determined that our company did not achieve our minimum corporate performance internal targets with revenue of $117.7 million and $41.7 million in non-GAAP operating loss.

The Compensation Committee did not approve any bonus payments for our executive officers for the first half of fiscal year 2008 based on the corporate performance results discussed above. However, pursuant to the terms of their employment letter agreements, Dr. Ruscev received a guaranteed bonus payment of $250,000 and Mr. Vernet received a guaranteed bonus payment of $73,125 for the first half of fiscal year 2008. Dr. Ruscev's employment letter agreement provides for a target bonus of 100% of base salary with the opportunity to earn 200% of base salary based on extraordinary achievement of objectives. For 2008, his annual bonus is guaranteed at 100% of base salary. Mr. Vernet's employment letter agreement provides for a target bonus of 90% of base salary. For the first half of fiscal year 2008, his semi-annual bonus is guaranteed at 100% of base salary, but prorated based upon Mr. Vernet's start date through the end of the bonus period.

During the second half of fiscal year 2008, the Compensation Committee divided the corporate performance objectives into financial and operational objectives. The corporate financial objectives were revenue and non-GAAP free cash flow from operations. We derive non-GAAP free cash flow from operations by calculating our company's operating income in accordance with GAAP and adding stock-based compensation expense under FAS123 (R) and depreciation and amortization expense, and by subtracting capital expenditures and working capital impacts of accounts receivable, accounts payable, accrued liabilities and inventory. The corporate operational objectives related to product development and qualification, next generation technology development, achievement of Korea assembly and test certification for certain products as part of our global regionalization strategy and reduction of certain product lead times. Each corporate financial objective was weighted at 25% and the corporate operational objectives were weighted between 3.3% and 10% for a total combined objective of 50%. For employee retention purposes, the Compensation Committee determined not to condition payment of bonuses for the second half of fiscal year 2008 on the achievement of the minimum corporate financial objectives. The Compensation Committee weighted each of the combined financial objectives and the combined operational objectives at 50% for Drs. Khandros and Ruscev. For our other executive officers, the Committee weighted the combined financial objectives at 40% and the combined operational objectives at 40%, with the remaining 20% consisting of individual performance objectives as discussed above.

Bonus payments for the second half of fiscal year 2008 under the Employee Incentive Plan for our executive officers, other than Drs. Khandros and Ruscev, were determined by multiplying (a) base salary paid for the performance period (Base) by (b) target percentage (Target) by (c) ((corporate achievement factor × individual achievement factor × 80%) [Corporate Factor] + (individual achievement factor × 20%) [Individual Factor]) or

BASE × TARGET × (CORPORATE FACTOR + INDIVIDUAL FACTOR) = BONUS.

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For the second half of fiscal year 2008, the Compensation Committee determined that our company achieved 36.3% of its corporate performance objectives. Our non-GAAP free cash flow from operations was $(25.6) million, which fell below our internal target of $(6) million, and our revenue of $92.5 million was below our internal target of $125 million. However, we did achieve 86% of our corporate operational objectives. Specifically, we qualified certain dual temperature Harmony architecture products with our customers as planned, qualified TRE test technology and RapidSoak thermal compensation technology with certain of our planned customers, progressed in our next generation technology development with one customer early adopter engagement delayed, obtained certification for certain assembly and test operations at our Korea facility as planned, and achieved 75% of our planned reduction in product lead times. Individual performance factors for our executive officers ranged from 85% to 100%.

The Compensation Committee approved the following bonus payments for our executive officers for the second half of fiscal year 2008 based on the performance results discussed above:

| Executive Officer | 2008 Annual Target (% of Base Salary) | 2nd Half 2008 Target (% of Base Salary) | 2nd Half 2008 Actual Bonus (% of Target) | Bonus Paid for 2nd Half 2008 |
|---|---|---|---|---|
| Dr. Igor Y. Khandros | 135% | 67.5% | 36.6% | $ 98,952 |
| Dr. Mario Ruscev (1) | 100 | 50 | 100 | 250,000 |
| Jean B. Vernet | 90 | 45 | 49 | 71,721 |
| Richard M. Freeman | 90 | 45 | 41.7 | 61,901 |
| Stuart L. Merkadeau | 90 | 45 | 44 | 55,458 |
| Ronald C. Foster (2) | 90 | 45 | | |
| Jorge L. Titinger (3) | 90 | 45 | | |

(1) Dr. Ruscev's guaranteed bonus payment was made pursuant to the terms of his employment letter agreement.

(2) Mr. Foster resigned from our company effective as of March 21, 2008.

(3) Mr. Titinger's last day of employment with our company was June 7, 2008.

Bonuses paid to our 2008 executive officers for the second half of fiscal year 2008 were between 42% 49% of the second half targets, and bonuses paid for the full year were between 21% 25% of the full year targets, which for both periods was less than the 50th percentile of our peer group.

*Equity*

Our 2002 Equity Incentive Plan authorizes the award of stock options, restricted stock and restricted stock units to our executive officers. Equity awards to our officers are made at the discretion of the Compensation Committee in accordance with the 2002 Equity Incentive Plan and our company's equity grant guidelines. Compensation tied to the performance of our company's common stock is used to reward performance and contributions to our company, as well as for retention purposes.

The Compensation Committee believes that equity compensation is a very important component of our pay-for-performance compensation philosophy, and is an effective way to align compensation for executive officers over a multi-year period directly with the interests of our company's stockholders by motivating and rewarding creation and preservation of stockholder value. Our stockholders approved a proposal at our 2008 annual meeting intended to preserve full deductibility of equity compensation to our executive officers under the 2002 Equity Incentive Plan.

Because of the "underwater value" of previously granted stock options and for retention purposes, in February 2008, the Compensation Committee for the first time made annual grants of restricted stock units to employees below the vice president level and granted a mix of stock options and restricted stock units to vice presidents and above, except for Dr. Khandros who received only stock

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options. At this time, the Compensation Committee is of the view that the preponderance of our Chief Executive Officer's equity compensation should only result in value to him if stockholder value increases through increases in our share price. Based on a review of his performance in 2008, Dr. Khandros was granted the same number of options in 2008 as he received in 2007.

The 2008 equity grants to our executive officers were made between the median and 75th percentile of our 2007 peer group. Subject to the officer's continued service with our company, the stock options will vest 25% after one year and monthly thereafter over the next three years and the restricted stock units will vest 25% each year over four years. Our executive officers and other employees receive value from stock options only to the extent that our company's stock price, and therefore, stockholder value, increases from the stock price on the grant date. Restricted stock units are impacted by all stock price changes, so the value to executive officers and other employees is affected by both increases and decreases in stock price. In February 2008, the Compensation Committee made the following equity awards to our executive officers, except for the new hire/promotion equity awards to Dr. Ruscev and Mr. Vernet that are set forth in the table below:

| Executive Officer | 2008 Stock Option Awards (#) | 2008 Restricted Stock Unit Awards (#) |
|---|---|---|
| Dr. Igor Y. Khandros | 100,000 | |
| Dr. Mario Ruscev (1) | 300,000 | 40,000 |
| Jean B. Vernet (2) | 50,000 | 20,000 |
| Richard M. Freeman | 25,000 | 10,000 |
| Stuart L. Merkadeau | 25,000 | 10,000 |
| Ronald C. Foster (3) | | |
| Jorge L. Titinger (4) | 35,000 | 14,000 |

(1) Represents a new hire grant of 100,000 options and an award of 40,000 restricted stock units to Dr. Ruscev in connection with his appointment as President in January 2008 and a grant of 200,000 options in connection with his promotion to Chief Executive Officer in June 2008.

(2) Represents new hire awards to Mr. Vernet when he joined our company.

(3) Mr. Foster resigned from our company effective as of March 21, 2008.

(4) Mr. Titinger's last day of employment with our company was June 7, 2008.

See the table entitled "Grants of Plan-Based Awards  Fiscal Year 2008" under "Executive Compensation and Related Information" in this Proxy Statement for additional information regarding equity awards to our executive officers in fiscal year 2008.

The Compensation Committee also desires to create the appropriate balance between equity-based executive pay and stockholder concerns about stock usage and dilution. Accordingly, the Compensation Committee has taken the following steps to manage our company's equity compensation plan:

- our net issuance of stock-based awards was 1.6% of outstanding common stock in fiscal year 2008, which is within the average for companies that operate within our 2008 peer group; and

- we have determined under our guidelines for equity awards that one restricted stock unit equals an option to purchase 2.5 shares of our common stock when we conduct competitive market analyses and evaluate potential employee equity awards.

Equity awards to our executive officers are generally made on an annual basis, along with the annual equity awards made to all other employees of our company. For 2008, the Compensation Committee changed its annual grant date from May to February to assist with our company's employee retention program. For 2009, the Compensation Committee plans to return the grant date for its annual equity award

program to May. All annual grants are made at a regularly scheduled meeting of

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the Compensation Committee under our guidelines for equity awards and during an open trading window under our company's insider trading policy.

To enhance our employee retention and recruiting efforts in the face of significant business challenges and the decline in our stock price, in September 2008, we submitted to our stockholders a proposal to grant an opportunity for our employees, other than our executive officers and members of our Board of Directors, to exchange certain out-of-the-money options for a smaller number of new equity awards. In October 2008, we withdrew the stock option exchange offer proposal that was scheduled to be considered at a special meeting of our stockholders. We may consider an exchange offer as part of our long-term equity incentive retention policy, and depending on market conditions and our retention needs, we may resubmit this proposal in the future to our stockholders.

Our executive officers are also eligible to participate in our 2002 Employee Stock Purchase Plan on the same terms as all other employees of our company. The 2002 Employee Stock Purchase Plan permits our eligible employees (including officers) to purchase shares of our common stock at a discount on a periodic basis through payroll deductions of between 1% and 15% of their cash compensation. The offering periods under the Employee Stock Purchase Plan are a 12 month fixed offering period commencing on February 1 of each calendar year and ending on January 31 of the subsequent calendar year, and a six month fixed offering period commencing on August 1 of each calendar year and ending on January 31 of the subsequent calendar year. The 12 month offering period consists of two six month purchase periods and the six month offering period consists of one six month purchase period. The purchase price for shares of our common stock purchased under this plan is 85% of the lesser of the fair market value of our common stock on the first day of the applicable offering period or the last day of each purchase period. No participant may purchase shares under this plan having a fair market value of more than $25,000, which is determined as of the first day of the applicable offering period, for each calendar year.

**Stock Ownership Guidelines**

We have stock ownership guidelines for our executive officers and members of our Board of Directors, which are set forth in our company's Governance Guidelines. Our Governance Guidelines state that each independent director should hold at least the lesser of 5,000 shares or shares equal in value to three times the annual cash retainer for service as a director, and that each executive officer should hold at least the lesser of 10,000 shares or shares equal in value to twice the executive officer's annual base salary. Beginning January 2009, members of our Board and executive officers will have three years to meet these ownership guidelines. Going forward, new members of our Board will have three years and new executive officers will have three years from the time they become executive officers to meet the ownership guidelines. In the event the requisite number of shares is increased by our Board, our Board members and executive officers, as applicable, will have two years from the time of the increase to acquire any additional shares needed to meet the revised guidelines.

**Change of Control Benefits**

In February 2008, we revised and renewed our change of control severance agreements with our executive officers based on a competitive review by FWC of similar agreements in the 2008 peer group, which agreements are described in this Proxy Statement under "Executive Compensation and Related Information  Change of Control, Severance, Separation and Indemnification Agreements." The Compensation Committee believes that these agreements protect the interests of our stockholders by providing a framework for avoiding the distraction and loss of key management personnel that may occur in connection with rumored or actual fundamental corporate changes. The uncertainty about future status of employment among management that can arise in the face of a potential change of control could result in the untimely departure or distraction of key officers. Change of control agreements provide support to officers to remain with our company despite uncertainties while a

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change of control is under consideration or pending and the Compensation Committee believes that the potential benefits under these agreements are reasonable when compared to competitive agreements offered by our peer companies to their senior executives.

Under our Employee Incentive Plan, which provides for performance bonuses to our executive officers, if a change in control of our company occurs, all bonus awards will be deemed to have been earned at 100% of the bonus target percentage for the current plan measurement period (and for the subsequent consecutive measurement periods if they fall within the same fiscal year) and will be paid to the participants at that time.

**Other Benefits and Perquisites**

Our executive officers participate in various employee benefit plans, including health, dental and vision care plans, life insurance and our company's 401(k) plan as our other employees. Our company's 401(k) is a defined contribution plan and provides for a company match of 50% for the first 3% of an employee's contributions to the plan. Based on our company's profitability, we match up to 7.5% of an employee's pay. Our company's contributions vest over four years from the employee's hire date for both the company match and profit-sharing portions.

**Tax Considerations**

Section 162(m) of the Internal Revenue Code of 1986, as amended, establishes a limitation on the deductibility of compensation payable in any particular tax year to our Chief Executive Officer and the three other most highly compensated officers of our company excluding our Chief Financial Officer. Section 162(m) of the Code generally provides that publicly-held companies cannot deduct compensation paid to its top officers to the extent that such compensation exceeds $1 million per officer. Compensation that is "performance-based" compensation within the meaning of the Code is exempted from the $1 million deduction limit.

While the Compensation Committee attempts to maximize the deductibility of compensation paid to our Chief Executive Officer and the three other most highly compensated officers, the Committee retains the discretion and flexibility necessary to provide total compensation in line with competitive practice, our compensation philosophy and the interests of our stockholders. Accordingly, from time to time, the Compensation Committee may approve, and our company may pay, compensation to our officers that are not fully deductible under Section 162(m). For example, our Employee Incentive Plan does not meet the requirements for a "performance-based plan" under Section 162(m), and so if cash compensation for a covered executive officer exceeds $1 million, the excess would not be deductible. However, our stockholders approved certain material terms of our company's 2002 Equity Incentive Plan at our 2008 Annual Meeting of Stockholders so that the taxation of option awards under the plan to covered executive officers can be exempt from Section 162(m).

Our change of control severance agreements discussed below in the "Executive Compensation and Related Information  Change of Control, Severance, Separation and Indemnification Agreements" section of this Proxy Statement are designed to comply with the requirements of Section 409A of the Internal Revenue Code.

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**REPORT OF THE COMPENSATION COMMITTEE**

The Compensation Committee reviewed and discussed the "Compensation Discussion and Analysis" contained in this Proxy Statement with our company's management. Based on this review and discussions, the Compensation Committee has recommended to FormFactor's Board of Directors that the "Compensation Discussion and Analysis" be included in this Proxy Statement.

Submitted by the Compensation Committee

James A. Prestridge, Chairperson
Dr. Homa Bahrami
G. Carl Everett, Jr.
Lothar Maier

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## EXECUTIVE COMPENSATION AND RELATED INFORMATION

### Summary Compensation

The following table presents information regarding the compensation paid during fiscal year 2008, 2007 and 2006 to our current Executive Chairman of the Board of Directors and former Chief Executive Officer, our current Chief Executive Officer, our current Chief Financial Officer, our former Chief Financial Officer and the three other most highly compensated executive officers who served during fiscal year 2008.

| Name and Principal Position | Year | Salary ($) | Bonus ($) | Stock Awards ($)(10) | Option Awards ($)(10) | Non-Equity Incentive Plan Compensation ($)(13) | All Other Compensation ($)(14) | Total ($) |
|---|---|---|---|---|---|---|---|---|
| Dr. Igor Y. Khandros(1) | 2008 | $ 451,923 | | $ 33,639 | $ 1,640,592 | $ 98,952 | $ 3,450 | $ 2,228,556 |
| Executive Chairman of the Board of Directors and former Chief Executive Officer | 2007 | 487,394 | | 127,548 | 1,517,448 | 530,234 | 20,250 | 2,682,874 |
| | 2006 | 436,835 | | 127,548 | 1,324,428 | 571,981 | 23,022 | 2,483,814 |
| Dr. Mario Ruscev(2) | 2008 | 480,769 | 100,000(7) | 291,384 | 518,539 | 490,385 | 56,113 | 1,937,190 |
| Chief Executive Officer and former President | 2007 | | | | | | | |
| | 2006 | | | | | | | |
| Jean B. Vernet(3) | 2008 | 237,500 | 100,000(8) | 70,857 | 83,654 | 144,846 | 48,439 | 685,296 |
| Senior Vice President, Chief Financial Officer | 2007 | | | | | | | |
| | 2006 | | | | | | | |
| Richard M. Freeman(4) | 2008 | 330,000 | | 41,211 | 936,169 | 61,901 | 3,450 | 1,372,731 |
| Senior Vice President, Operations | 2007 | 319,577 | | | 858,850 | 231,244 | 20,250 | 1,456,998 |
| | 2006 | 285,962 | | | 624,875 | 285,811 | 15,797 | 1,212,445 |
| Stuart L. Merkadeau | 2008 | 269,561 | | 41,211 | 680,526 | 55,458 | 3,450 | 1,050,206 |
| Senior Vice President, General Counsel and Secretary | 2007 | 259,896 | | | 751,093 | 193,487 | 20,250 | 1,390,325 |
| | 2006 | 259,896 | | | 727,434 | 216,416 | 15,371 | 1,219,117 |
| ***Former Officers:*** | | | | | | | | |
| Ronald C. Foster(5) | 2008 | 97,815 | | | 1,180,206(11) | | 235,390 | 1,513,411 |
| Former Senior Vice President, Chief Financial Officer | 2007 | 304,231 | | | 712,639 | 209,231 | 20,250 | 1,271,912 |
| | 2006 | 285,962 | | | 484,310 | 261,993 | 18,606 | 1,050,871 |
| Jorge L. Titinger(6) | 2008 | 165,123 | | 287,233 | 29,709(12) | | 207,233 | 689,287 |
| Former Senior Vice President, Product Business Group | 2007 | 40,385 | 200,000(9) | 22,741 | 57,601 | | | 320,727 |
| | 2006 | | | | | | | |

(1) Dr. Khandros served as Chief Executive Officer of our company until he was appointed Executive Chairman of the Board of Directors effective June 28, 2008, at which point he reduced his hours to four days per week, with a proportionate reduction in base salary.

(2) Dr. Ruscev joined our company on January 7, 2008 as President. Effective June 28, 2008, we promoted him to Chief Executive Officer.

(3) Mr. Vernet joined our company on March 31, 2008 as Senior Vice President, Chief Financial Officer.

(4) Mr. Freeman has served as our company's Senior Vice President, Manufacturing since January 2009. Mr. Freeman was our Senior Vice President, Operations from September 2004 to December 2008.

(5) Mr. Foster resigned from our company effective as of March 21, 2008.

(6)

We mutually agreed with Mr. Titinger to eliminate his position as part of our company's restructuring that we announced in our first fiscal quarter of 2008. Mr. Titinger's last day of employment was June 7, 2008.

(7)

Represents Dr. Ruscev's sign-on bonus, which we provided when he joined our company.

(8)

Represents Mr. Vernet's sign-on bonus, which we provided when he joined our company.

(9)

Represents Mr. Titinger's sign-on bonus, which we provided when he joined our company.

(10)

The amounts reflect the dollar amount recognized for the applicable fiscal year for financial statement reporting purposes in accordance with FAS123(R), excluding the impact of estimated forfeitures. Assumptions used in the calculation of these

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amounts are described in Note 9 Stock-Based Compensation to our company's consolidated financial statements in our Annual Report on Form 10-K for the fiscal year ended December 27, 2008.

(11)

The amount represents FAS123(R) option expense of $985,631 plus adjustments of $194,575.

(12)

The amount represents FAS123(R) expense of $515,030 less forfeitures of $485,321.

(13)

Represents amounts earned for performance in the applicable year under our company's Employee Incentive Plan (known as the Key Employee Bonus Plan prior to August 2008), which is described under "Compensation Discussion and Analysis" in this Proxy Statement.

(14)

The following table provides detail regarding "All Other Compensation."

**All Other Compensation**

| Name | Year | Severance Benefits | 401(k) Profit Sharing Contributions(c) | 401(k) Matching Contributions(d) | Relocation Allowance | Vehicle Allowance |
|---|---|---|---|---|---|---|
| Dr. Igor Y. Khandros | 2008 | $ | $ | $ 3,450 | $ | $ |
| | 2007 | | 16,875 | 3,375 | | |
| | 2006 | | 14,550 | 1,272 | | 7,200 |
| Dr. Mario Ruscev | | | | | | |
| | 2008 | | | | 56,113(e) | |
| | 2007 | | | | | |
| | 2006 | | | | | |
| Jean B. Vernet | | | | | | |
| | 2008 | | | 3,450 | 44,989(f) | |
| | 2007 | | 16,875 | 3,375 | | |
| | 2006 | | 14,550 | 4,056 | | |
| Richard M. Freeman | | | | | | |
| | 2008 | | | 3,450 | | |
| | 2007 | | 16,875 | 3,375 | | |
| | 2006 | | 14,550 | 1,247 | | |
| Stuart L. Merkadeau | | | | | | |
| | 2008 | | | 3,450 | | |
| | 2007 | | 16,875 | 3,375 | | |
| | 2006 | | 14,550 | 821 | | |
| Ronald C. Foster | | | | | | |
| | 2008 | 232,500(a) | | 2,890 | | |
| | 2007 | | 16,875 | 3,375 | | |
| | 2006 | | 14,550 | 4,056 | | |
| Jorge L. Titinger | | | | | | |
| | 2008 | 204,167(b) | | 3,056 | | |
| | 2007 | | | | | |
| | 2006 | | | | | |

(a)

Represents cash severance payment to Mr. Foster under his Separation Agreement and General Release.

(b)

Represents cash severance payment to Mr. Titinger under his Separation Agreement and General Release.

(c)

401(k) profit sharing contributions by our company. We did not make any contributions in fiscal year 2008. These contributions are subject to vesting.

(d)

401(k) matching contributions by our company, which contributions are subject to vesting.

(e)

Represents the relocation allowance paid to Dr. Ruscev.

(f)

Represents the relocation allowance paid to Mr. Vernet.

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**Grants of Plan-Based Awards in Fiscal Year 2008**

The following table presents information regarding stock options and restricted stock units granted during fiscal year 2008 to our executive officers named in the summary compensation table above. We granted these equity awards to these officers under our 2002 Equity Incentive Plan. The options have an exercise price equal to the closing price of our company's common stock on the Nasdaq Global Market on the grant date and have a seven-year term. The vesting schedules for the stock options and restricted stock units are set forth below in the "Outstanding Equity Awards at Fiscal Year Ended December 27, 2008" table. There can be no assurance that the Grant Date Fair Value of Stock and Option Awards will ever be realized. The following table also presents information regarding potential awards under our Employee Incentive Plan (known as the Key Employee Bonus Plan prior to August 2008) for fiscal year 2008 under the "Non-Equity Incentive Plan Awards" columns. All awards presented in the table below are further described under "Compensation Discussion and Analysis  Compensation Decisions  Equity" in this Proxy Statement.

| | Estimated Future Payouts Under Non-Equity Incentive Plan Awards(1) | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Name | Threshold ($) | Target ($) | Maximum ($) | Grant Date for Stock and Option Awards | All Other Stock Awards: Number of Shares of Stock or Units | All Other Option Awards: Number of Securities Underlying Options | Exercise or Base Price of Option Awards ($/sh) | Grant Date Fair Value of Stock and Option Awards ($)(2) |
| Dr. Igor Y. Khandros | | 540,000 | 1,080,000 | 2/20/08 | | 100,000 | 19.36 | 925,140 |
| Dr. Mario Ruscev | | 500,000 | 1,000,000 | 1/7/08 | | 100,000 | 29.98 | 1,438,050 |
| | | | | 1/7/08 | 40,000 | | | 1,199,200 |
| | | | | 8/6/08 | | 200,000 | 18.09 | 1,727,820 |
| Jean B. Vernet | | 292,500 | 541,125 | 3/31/08 | | 50,000 | 19.10 | 450,990 |
| | | | | 3/31/08 | 20,000 | | | 382,000 |
| Richard M. Freeman | | 297,000 | 549,450 | 2/20/08 | | 25,000 | 19.36 | 231,285 |
| | | | | 2/20/08 | 10,000 | | | 193,600 |
| Stuart L. Merkadeau | | 252,000 | 466,200 | 2/20/08 | | 25,000 | 19.36 | 231,285 |
| | | | | 2/20/08 | 10,000 | | | 193,600 |
| Ronald C. Foster | | | | | | | | |
| Jorge L. Titinger | | | | 2/20/08 | | 35,000 | 19.36 | 323,799 |
| | | | | 2/20/08 | 14,000 | | | 271,040 |

(1) The threshold calculations for the first half of fiscal year 2008 assume that our company has not met the minimum corporate performance under our Employee Incentive Plan (known as the Key Employee Bonus Plan prior to August 2008). There were no minimum corporate performance thresholds for the second half of fiscal year 2008 under the Employee Incentive Plan. Additional information regarding the corporate performance objectives for the semi-annual measurement periods in fiscal year 2008 and the actual awards paid to our executive officers in fiscal year 2008 under our Employee Incentive Plan is provided under "Compensation Discussion and Analysis  Compensation Decisions  Bonus" in this Proxy Statement.

(2) The amounts shown reflect the fair value of the equity award on the award date used to determine the compensation expense under FAS 123(R), excluding the impact of estimated forfeitures, associated with the award in our company's consolidated financial statements. The grant date fair value of option awards has been calculated using the Black-Scholes valuation model and the grant date fair value of stock awards has been calculated using the closing price on the grant date. The valuations are based on the assumptions discussed in Note 9  Stock-Based Compensation to our company's consolidated financial statements in our Annual Report on Form 10-K for the fiscal year ended December 27, 2008. Our company's use of these valuation models should not be interpreted as a prediction as to the actual value that may be realized on the award. The actual value of the award may be significantly different.

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**Outstanding Equity Awards at Fiscal Year Ended December 27, 2008**

The following table presents information regarding outstanding equity awards held by our executive officers named in the summary compensation table above at December 27, 2008.

| | Option Awards | | | | Stock Awards | |
|---|---|---|---|---|---|---|
| Name | Number of Securities Underlying Unexercised Options(#) Exercisable | Number of Securities Underlying Unexercised Options(#) Unexercisable | Option Exercise Price ($) | Option Expiration Date(1) | Number of Shares or Units of Stock That Have Not Vested(#) | Market Value of Shares or Units of Stock That Have Not Vested ($)(19) |
| Dr. Igor Y. Khandros | 104,228 | | 14.00 | 6/11/2013 | | |
| | 100,000 | | 19.50 | 8/14/2013 | | |
| | 30,000 | | 19.50 | 8/14/2013(2) | | |
| | 58,000 | | 23.56 | 2/15/2015(3) | | |
| | 75,000 | 25,000 | 25.39 | 11/4/2015(4) | | |
| | 65,770 | 65,770 | 39.84 | 5/11/2013(5) | | |
| | 25,000 | 75,000 | 41.39 | 5/16/2014(6) | | |
| | | 100,000 | 19.36 | 2/20/2015(7) | | |
| Dr. Mario Ruscev | | | | | | |
| | | 100,000 | 29.98 | 1/7/2015(8) | 40,000(16) | 538,800 |
| | | 200,000 | 18.09 | 8/6/2015(9) | | |
| Jean B. Vernet | | | | | | |
| | | 50,000 | 19.10 | 3/31/2015(10) | 20,000(17) | 269,400 |
| Richard M. Freeman | | | | | | |
| | 160,000 | | 17.51 | 9/17/2014(11) | | |
| | 30,000 | 10,000 | 25.39 | 11/4/2015(12) | | |
| | 18,510 | 18,510 | 39.84 | 5/11/2013(5) | | |
| | 10,320 | 10,320 | 39.84 | 5/21/2013(5) | | |
| | 15,000 | 45,000 | 41.39 | 5/16/2014(6) | | |
| | | 25,000 | 19.36 | 2/20/2015(13) | 10,000(18) | 134,700 |
| Stuart L. Merkadeau | | | | | | |
| | 2,077 | | 6.50 | 9/6/2011 | | |
| | 13,307 | | 6.50 | 10/30/2011 | | |
| | 52,500 | | 6.50 | 4/17/2012 | | |
| | 12,558 | | 14.00 | 6/11/2013 | | |
| | 63,000 | | 19.50 | 8/14/2013 | | |
| | 13,800 | | 19.50 | 8/14/2013(14) | | |
| | 28,000 | | 23.56 | 2/15/2015(14) | | |
| | 37,500 | 12,500 | 25.39 | 11/4/2015(15) | | |
| | 21,155 | 21,155 | 39.84 | 5/11/2013(5) | | |
| | 6,136 | 6,134 | 39.84 | 5/21/2013(5) | | |
| | 8,750 | 26,250 | 41.39 | 5/16/2014(6) | | |
| | | 25,000 | 19.36 | 2/20/2015(13) | 10,000(18) | 134,700 |
| Ronald C. Foster | | | | | | |
| | 90,200 | | 22.83 | 3/2/2015 | | |
| | 38,255 | | 39.84 | 5/11/2013 | | |
| | 16,667 | | 41.39 | 5/16/2014 | | |
| Jorge L. Titinger | | | | | | |

(1)

Unless otherwise indicated, option is fully vested. Vesting information is based on the original grant.

(2) Commenced vesting on April 15, 2007 in equal monthly installments over 12 months.

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(3) 50% vested on April 3, 2006 and the remaining 50% vested on April 3, 2008.

(4) 25% vests on each April 3 commencing on April 3, 2006.

(5) 25% vests on each May 11 commencing on May 11, 2007.

(6) 25% vests on each May 16 commencing on May 16, 2008.

(7) 25% vests on each February 20 commencing on February 20, 2009.

(8) 25% vests on January 7, 2009 and the remaining vests ratably each month to January 7, 2012.

(9) 25% vests on each August 6 commencing on August 6, 2009.

(10) 25% vests on March 31, 2009 and the remaining vests ratably each month to March 31, 2012.

(11) 25% vested on September 7, 2005 and the remaining vests ratably each month to September 7, 2008.

(12) 25% vests on each September 7 commencing on September 7, 2005.

(13) 25% vests on each February 20 commencing on February 20, 2009.

(14) Commenced vesting on July 5, 2007 in equal monthly installments over 12 months.

(15) 25% vests on each July 5 commencing on July 5, 2006.

(16) 25% vests on each January 7 commencing on January 7, 2009.

(17) 25% vests on each March 31 commencing on March 31, 2009.

(18) 25% vests on each February 20 commencing on February 20, 2009.

(19) Market value was determined by multiplying the price for a share of our company's common stock as of December 26, 2008 by the number of restricted stock units outstanding.

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**Option Exercises and Stock Vested at Fiscal Year Ended December 27, 2008**

The following table presents information concerning the exercise of options during fiscal year 2008 held by our executive officers named in the summary compensation table above, and the vested stock held by them at December 27, 2008.

| | Option Awards | | Stock Awards | |
|---|---|---|---|---|
| Name | Number of Shares Acquired on Exercise (#) | Value Realized on Exercise ($) | Number of Shares Acquired on Vesting (#) | Value Realized on Vesting ($) |
| Dr. Igor Y. Khandros | | | 8,500(1) | 184,875 |
| Dr. Mario Ruscev | | | | |
| Jean B. Vernet | | | | |
| Richard M. Freeman | | | | |
| Stuart L. Merkadeau | | | | |
| Ronald C. Foster | | | | |
| Jorge L. Titinger | | | 18,680(2) | 400,312 |

(1) On April 3, 2008, Dr. Khandros acquired 8,500 shares from the second and final settlement of one-half of the restricted stock units awarded to him on February 15, 2005. The closing price of our company's common stock on the Nasdaq Global Market on the settlement date was $21.75.

(2) On June 7, 2008, Mr. Titinger acquired 18,680 shares through the accelerated vesting and settlement of his restricted stock units pursuant to the Separation Agreement and General Release entered into by our company with Mr. Titinger. Of the 18,680 shares, we withheld 6,679 shares to satisfy Mr. Titinger's estimated tax withholding liability associated with the settlement of the restricted stock units. The closing price of our company's common stock on the Nasdaq Global Market on the settlement date was $21.43.

**Change of Control, Severance, Separation and Indemnification Agreements**

*Change of Control, Severance Agreements.* We have entered into change of control severance agreements with each of our executive officers and certain other officers. Each change of control severance agreement provides for the officer to receive the following severance benefits upon a qualifying termination of employment within one year following a change of control of our company, subject to the officer signing a release of claims in favor of our company:

- lump sum cash severance payment equal to one year's annual base salary and the greater of (a) the annual target bonus or (b) the annual target bonus multiplied by the average rate of annual bonus relative to target paid to officers covered by similar change of control severance agreements for the two most recently completed fiscal years (subject to the participating officer's compliance with a confidentiality agreement and an agreement not to solicit employees of our company for one year after termination),

- health benefits continuation for one year (subject to the participating officer's compliance with a confidentiality agreement and an agreement not to solicit employees of our company for one year after termination), and

- fully accelerated vesting of all equity awards, and unexercised stock options may be exercised for up to 18 months following a qualifying termination of employment but not to exceed the expiration date of such options.

Terminations of employment that entitle the officer to receive severance benefits under the change of control severance agreement consist of either termination by our company without "cause" or by

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resignation of the officer for "good reason" within 90 days of an event constituting "good reason" if in each case within one year following a "change of control". The change of control severance agreements provide the following definitions:

"*change of control*" means the first to occur of any of the following events:

(i) the consummation of a merger or consolidation of our company with any other corporation, other than a merger or consolidation which would result in the voting securities of our company outstanding immediately prior thereto continuing to represent (either by remaining outstanding or by being converted into or exchanged for voting securities of the surviving entity) more than 60% of the total voting power represented by the voting securities of our company or such surviving entity outstanding immediately after such merger or consolidation; or

(ii) (A) any approval by our stockholders of a plan of complete liquidation of our company, other than as a result of insolvency or (B) the consummation of the sale or disposition (or the last in a series of sales or dispositions) by our company of all or substantially all of our company's assets, other than a sale or disposition to a wholly-owned direct or indirect subsidiary of our company and other than a sale or disposition which would result in the voting securities of our company outstanding immediately prior thereto continuing to represent (by being converted into or exchanged for voting securities of the entity to which such sale or disposition was made) more than 60% of the total voting power represented by the voting securities of the entity to which such sale or disposition was made after such sale or disposition; or

(iii) any "*person*" (as defined in Sections 13(d) and 14(d) of the Securities Exchange Act of 1934) becoming the "*beneficial owner*" (as defined in Rule 13d-3 under the Securities Exchange Act of 1934), directly or indirectly, of securities of our company representing 40% or more of the total voting power represented by our company's then outstanding voting securities; or

(iv) during any period of two consecutive years after the effective date of the change of control severance agreement, the incumbent directors cease for any reason to constitute a majority of our Board of Directors.

"*cause*" means:

(i) any act of personal dishonesty taken by the employee in connection with his or her responsibilities as an employee which is intended to result in substantial personal enrichment of the employee and is reasonably likely to result in material harm to our company,

(ii) the employee's conviction of a felony,

(iii) a willful act by the employee which constitutes misconduct and is materially injurious to our company, or

(iv) continued willful violations by the employee of the employee's obligations to our company after the employee has received a written demand for performance from our company which describes the basis for our company's belief that the employee has not substantially performed his or her duties.

"*good reason*" means the occurrence of any of the following:

(i) without the employee's express written consent, a material reduction of the employee's duties, position or responsibilities relative to the employee's duties, position or responsibilities in effect immediately prior to the change of control;

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(ii) a reduction by our company of the employee's base salary or bonus opportunity as in effect immediately prior to such reduction;

(iii) a material reduction by our company in the kind or level of employee benefits to which the employee is entitled immediately prior to such reduction with the result that the employee's overall benefits package is materially reduced;

(iv) without the employee's express written consent, the relocation of the employee to a facility or a location more than five miles from his or her current facility and the new location is more than 50 miles from the employee's current residence; or

(v) the failure of our company to obtain the assumption of the change of control severance agreement by a successor.

The change of control severance agreements provide that if payments to an officer are subject to the excise tax imposed by Section 280G of the Internal Revenue Code, the severance benefits will be reduced to the extent that such reduction would increase the benefits received by the officer on an after-tax basis. The change of control severance agreements do not alter the at-will employment of the officers who have entered into them.

In addition to the benefits under the change of control severance agreements, our current stock option agreements under our stock option plans for our officers, including our 2002 Equity Incentive Plan, provide that in the event the officer's employment is terminated without cause within 12 months following a change in control, the officer will receive credit for an additional 12 months of service for purposes of calculating the number of shares of our common stock that are vested under such option.

Under our Employee Incentive Plan (known as the Key Employee Bonus Plan prior to August 2008), which provides for performance bonuses to our officers, if a change in control of our company occurs, all bonus awards will be deemed to have been earned at 100% of the bonus target percentage for the current plan measurement period (and for the subsequent consecutive measurement periods if they fall within the same fiscal year) and will be paid to the officer participants at that time.

The following table presents information regarding change of control payment and benefits estimates for our executive officers named in the summary compensation table above, other than Messrs. Foster and Titinger who terminated their employment with our company in fiscal year 2008 and received the separation benefits described below. We prepared the table assuming that both a change of control occurred and the employment of our current executive officers was terminated without cause or by resignation of the officer for good reason on December 27, 2008, which is our company's last business day of fiscal year 2008. For purposes of valuing the accelerated vesting of unvested equity awards, we have used the safe harbor valuation method based on the Black-Scholes valuation model permitted under Section 280G of the Internal Revenue Code and based on the closing share price of FormFactor common stock as of December 26, 2008, the last trading day of fiscal year 2008. The

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various amounts listed are estimates only. The actual amounts to be paid can only be determined at the time of such change of control and such officer's separation from our company.

| | Dr. Igor Y. Khandros | Dr. Mario Ruscev | Jean B. Vernet | Richard M. Freeman | Stuart L. Merkadeau |
|---|---|---|---|---|---|
| Base salary($) | $ 400,000 | $ 500,000 | $ 325,000 | $ 330,000 | $ 280,000 |
| Short-term incentive compensation($) | 540,000 | 500,000 | 292,500 | 297,000 | 252,000 |
| Stock options($) | | | | | |
| Stock awards($) | | 584,000 | 292,000 | 146,000 | 146,000 |
| Health benefits($) | 15,000 | 15,000 | 15,000 | 15,000 | 15,000 |
| Sub-Total: | 955,000 | **2-3 Years** | **4-5 Years** | **After 5 Years** | |
| 7.5% Convertible senior notes(1) | $ 33,458 | $ | $ | $ 33,458 | $ |
| 6.75% Convertible senior notes(2) | 7,000 | | 7,000 | | |
| 5.75% Convertible senior notes(3) | 23,250 | | | 23,250 | |
| 5.75% Convertible senior subordinated notes(4) | 16,907 | 16,907 | | | |
| 4.0% Convertible senior subordinated notes(5) | 55,150 | | 55,150 | | |
| 5.75% Convertible subordinated notes(6) | 2,910 | 2,910 | | | |
| Interest on convertible notes | 21,013 | 7,046 | 11,864 | 2,103 | |
| Operating leases: | | | | | |
| Facilities | 29,521 | 6,352 | 12,033 | 10,168 | 968 |
| Long-term obligations(7) | 2,155 | 500 | 805 | 850 | |
| Purchase commitments(8) | 3,461 | 958 | 640 | 1,064 | 799 |
| | $ 194,825 | $ 34,673 | $ 87,492 | $ 70,893 | $ 1,767 |

(1) The 7.5% convertible senior notes are convertible into shares of CTI common stock at a conversion rate of 119.6298 shares of common stock per $1,000 principal amount of the notes, which is equivalent to a conversion price of approximately $8.36 per share.

(2) The 6.75% convertible senior notes are convertible into shares of CTI common stock at a conversion rate of 95.0925 shares of common stock per $1,000 principal amount of the notes, which is equivalent to a conversion price of approximately $10.52 per share.

(3) The 5.75% convertible senior notes are convertible into shares of CTI common stock at a conversion rate of 333.3333 shares of common stock per $1,000 principal amount of the notes, which is equivalent to a conversion price of approximately $3.00 per share.

(4) The 5.75% convertible senior subordinated notes are convertible into shares of CTI common stock at a conversion rate of 25 shares of common stock per $1,000 principal amount of the notes, which is equivalent to a conversion price of $40.00 per share.

(5)

The 4.0% convertible senior subordinated notes are convertible into shares of CTI common stock at a conversion rate of 18.5185 shares of common stock per $1,000 principal amount of the notes, which is equivalent to a conversion price of approximately $54.00 per share.

(6) The 5.75% convertible subordinated notes are convertible into shares of CTI common stock at a conversion rate of 7.353 shares of common stock per $1,000 principal amount of the notes, which is equivalent to a conversion price of approximately $136.00 per share.

(7) Long-term obligations does not include $6.2 million of contingent consideration related to our acquisition of Zevalin, $1.5 million related to excess facilities charges and $1.0 million recorded as a long-term obligation for benefits owed to our Italian employees pursuant to Italian Law. The timing of the payments related to this obligation is unknown as the benefit is paid upon an employee s separation from the Company.

(8) We purchase Zevalin from Biogen pursuant to a supply agreement that we entered into with Biogen on December 21, 2007 in connection with the acquisition of U.S. rights to develop, market and sell Zevalin. Under the terms of the supply agreement, we are required to purchase from Biogen an amount of Zevalin every six months. We provide rolling forecasts of our supply requirements to Biogen in six-month increments for the next 30 months; however, under the terms of the agreement we are required to purchase a minimum of 150 packages, or 300 kits, for each six-month period in 2008, 2009 and 2010, and a minimum of 250 packages, or 500 kits, for each six-month period thereafter until the expiration of the term on June 9, 2014, unless earlier terminated. Each forecast for the next six-month period must be accompanied by a firm order.

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*Additional Milestone Activities*

Pursuant to the amended agreement with PG-TXL Company L.P. which grants us an exclusive worldwide license for the rights to paclitaxel poliglumex and to all potential uses of PG-TXL s polymer technology, we may be required to pay $14.9 million in milestone payments. We filed an MAA with the EMEA on March 4, 2008. We will be required to make a $0.5 million payment within 30 days of the EMEA s acceptance of our MAA filing, which is expected to occur at the end of the first quarter of 2008. Additionally, we will be required to make a $3.0 million payment upon approval of the MAA filing by the EMEA, which is expected to occur in the second half of 2009. The timing of the remaining milestone payments under the amended agreement is based on trial commencements and completions and regulatory and marketing approval with the FDA and EMEA.

Under a license agreement entered into for brostallicin, we may be required to pay up to $80 million in milestone payments, based on the achievement of certain product development results. Due to the early stage of development that brostallicin is in, we are not able to determine whether the clinical trials will be successful and therefore cannot make a determination that the milestone payments are reasonably likely to occur at this time.

Pursuant to an acquisition agreement entered into with Cephalon, Inc. in June 2005, we may receive up to $100 million in payments upon achievement by Cephalon of specified sales and development milestones. However, the achievement of any such milestones is uncertain.

Under our agreement with Novartis Pharmaceutical Company Ltd., or Novartis, if Novartis elects to participate in the development and commercialization of paclitaxel poliglumex or if Novartis exercises its option to develop and commercialize pixantrone, we may receive up to $374 million in registration and sales related milestone payments. Novartis is under no obligation to make such election or exercise such right and may never do so. Additionally, even if Novartis exercises such rights, any milestone payments we may be eligible to receive from Novartis are subject to the receipt of the necessary regulatory approvals which we may never receive.

**Impact of Inflation**

In the opinion of management, inflation has not had a material effect on our operations including selling prices, capital expenditures and operating expenses.

**Recent Accounting Pronouncements**

On December 4, 2007, Statement of Financial Standard No. 141(R), *Business Combinations,* or SFAS 141(R), was issued. This standard will require 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 as an indefinite lived intangible asset and either amortize it over the life of the product, or write it off if the project is abandoned or impaired. The acquiring company will be required to expense the acquisition costs rather than be added to the cost of the acquisition. The standard is effective for transactions occurring on or after January 1, 2009. We are evaluating the impact this standard will have on our financial statements.

On December 4, 2007, Statement of Financial Standard No. 160, *Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51*, or SFAS 160, was issued. This standard changes the accounting for and reporting of noncontrolling or minority interests in consolidated financial statements. The standard is effective January 1, 2009; however, the presentation and disclosure requirements of SFAS 160 regarding noncontrolling interests shall be applied retrospectively. We are evaluating the impact, if any, this standard will have on our financial statements.

In November 2007, the EITF reached a consensus on Issue 07-1. EITF 07-1, *Accounting for Collaborative Arrangements Related to the Development and Commercialization of Intellectual Property*, is focused on how the

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parties to a collaborative agreement should account for costs incurred and revenue generated on sales to third parties, how sharing payments pursuant to a collaborative agreement should be presented in the income statement and certain related disclosure questions. EITF 07-1 is effective for periods beginning after December 15, 2008. We are evaluating the requirements of these issues and have not yet determined the impact on the financial statements.

In June 2007, the EITF reached a consensus on Issue 07-3, *Accounting for Nonrefundable Advance Payments for Goods or Services to Be Used in Future Research and Development Activities,* or EITF 07-3, which focuses on whether non-refundable advance payments for goods or services that will be performed in future research and development activities should be accounted for as research and development costs or deferred and capitalized until the goods have been delivered or the related services have been rendered. EITF 07-3 is effective for periods beginning after December 15, 2007. We are evaluating the impact, if any, this EITF will have on our financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115*, or SFAS 159. The Statement permits entities to choose, at specified election dates, to measure many financial instruments and certain other items at fair value that are not currently measured at fair value. Unrealized gains and losses on items for which the fair value option has been elected would be reported in earnings at each subsequent reporting date. SFAS 159 also establishes presentation and disclosure requirements in order to facilitate comparisons between entities choosing different measurement attributes for similar types of assets and liabilities. SFAS 159 does not affect existing accounting requirements for certain assets and liabilities to be carried at fair value. SFAS 159 is effective for fiscal years beginning after November 15, 2007, and adopted by us beginning January 1, 2008. We are evaluating the requirements of SFAS 159 and have not yet determined the impact on the financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, or SFAS 157, which provides guidance on how to measure assets and liabilities that use fair value. This statement clarifies the principle that fair value should be based on the assumptions market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. SFAS 157 will apply whenever another generally accepted accounting principle requires, or permits, assets or liabilities to be measured at fair value but does not expand the use of fair value to any new circumstances. This statement will also require additional disclosures in both annual and quarterly reports. SFAS 157 is effective for fiscal years beginning after November 2007, and adopted by us beginning January 1, 2008. We are evaluating the impact, if any, this standard will have on our financial statements.

**Item 7a. Quantitative and Qualitative Disclosures about Market Risk**

*Interest Rate Market Risk*

We are exposed to market risk related to changes in interest rates that could adversely affect the value of our investments. We maintain a short-term investment portfolio consisting of interest bearing securities with an average maturity of less than one year. These securities are classified as available-for-sale . These securities are interest bearing and thus subject to interest rate risk and will fall in value if market interest rates increase. Since we generally hold our fixed income investments until maturity, we do not expect our operating results or cash flows to be affected to any significant degree by a sudden change in market interest rates related to our securities portfolio. The fair value of our securities available-for-sale at December 31, 2007 and 2006 was $2.5 million and $36.7 million, respectively. For each one percent change in interest rates, the fair value of our securities available-for-sale would change by approximately $12,000 and $135,000 as of December 31, 2007 and 2006, respectively.

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*Foreign Exchange Market Risk*

We are exposed to risks associated with foreign currency transactions insofar as we use U.S. dollars to make contract payments denominated in euros or vice versa. As the net positions of our unhedged foreign currency transactions fluctuate, our earnings might be negatively affected. In addition, we are exposed to risks associated with the translation of euro-denominated financial results and accounts into U.S. dollars. Although our reporting currency remains the U.S. dollar, a significant portion of our consolidated costs now arise in euros, which we translate into U.S. dollars for purposes of financial reporting, based on exchange rates prevailing during the applicable reporting period. In addition, the reported carrying value of our euro-denominated assets and liabilities will be affected by fluctuations in the value of the U.S. dollar as compared to the euro. Accordingly, changes in the value of the U.S. dollar relative to the euro might have an adverse effect on our reported results of operations and financial condition, and fluctuations in exchange rates might harm our reported results and accounts from period to period.

We have foreign exchange risk related to euro-denominated cash, cash equivalents and interest receivable ( foreign funds ). Based on the balance of foreign funds at December 31, 2007 of $5.5 million, an assumed 5%, 10% and 20% negative currency movement would result in fair value declines of $0.3 million, $0.6 million and $1.1 million, respectively.

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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

Shareholders of Cell Therapeutics, Inc.

We have audited Cell Therapeutics, Inc. s internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Cell Therapeutics, Inc. s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management s Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. 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 audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

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 (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) 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 (3) 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.

In our opinion, Cell Therapeutics, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

As described in Management s Report on Internal Controls appearing under item 9A, management has excluded Systems Medicine, LLC and the commercial product Zevalin, from its assessment of internal controls over financial reporting as of December 31, 2007 because they were acquired by the Company during 2007. We have also excluded Systems Medicine, LLC, whose financial statements reflect total assets of 1% and net sales of 0%, respectively, of the related consolidated financial statements as of and for the year then ended December 31, 2007 and the commercial product Zevalin, whose financial statements reflect total assets of 21% and net sales of 37%, respectively, of the related consolidated financial statements as of and for the year ended December 31, 2007, from our audit of internal control over financial reporting.

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We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the balance sheets and the related statements of operation, stockholders deficit and other comprehensive loss, and cash flows of Cell Therapeutics, Inc., and our report dated March 26, 2008 expressed an unqualified opinion.

/s/ Stonefield Josephson, Inc.

Stonefield Josephson, Inc.

Los Angeles, CA

March 26, 2008

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

Board of Directors and Shareholders

Cell Therapeutics, Inc.

We have audited the accompanying balance sheets of Cell Therapeutics, Inc. as of December 31, 2007 and 2006, and the related statements of operations, shareholders deficit and other comprehensive loss, and cash flows for each of the years in the three-year period ended December 31, 2007. Our audits also included the consolidated financial statement schedule listed in the index at Item 15(a)(ii) as of and for the years ended December 31, 2007 and 2006. Cell Therapeutics Inc. s management is responsible for these financial statements and schedule. Our responsibility is to express an opinion on these financial statements and schedule based on our 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 audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Cell Therapeutics, Inc. as of December 31, 2007 and 2006, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2007 in conformity with accounting principles generally accepted in the United States of America.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 1 to the consolidated financial statements, the Company has substantial monetary liabilities in excess of monetary assets as of December 31, 2007, including approximately nineteen million, eight hundred thousand dollars of convertible subordinated notes and senior subordinated notes which mature in June 2008. The Company s ability to satisfy these obligations upon maturity raises substantial doubt about the Company s ability to continue as a going concern. Management s plans concerning these matters are described in Note 1. These consolidated financial statements do not include any adjustments relating to the recoverability and classification of recorded assets, or the amounts and classification of liabilities that might be necessary in the event the Company cannot continue in existence.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Cell Therapeutics, Inc. s internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 26, 2008 expressed an unqualified opinion.

/s/ Stonefield Josephson, Inc.

Stonefield Josephson, Inc.

Los Angeles, Ca

March 26, 2007

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**CELL THERAPEUTICS, INC.**

**CONSOLIDATED BALANCE SHEETS**

**(In thousands, except share amounts)**

| | December 31, 2007 | December 31, 2006 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 15,798 | $ 17,129 |
| Securities available-for-sale | 2,548 | 36,708 |
| Interest receivable | 46 | 570 |
| Accounts receivable, net | 51 | |
| Inventory | 290 | |
| Prepaid expenses and other current assets | 3,904 | 10,131 |
| Total current assets | 22,637 | 64,538 |
| Property and equipment, net | 6,025 | 7,915 |
| Goodwill | 17,064 | 17,064 |
| Other intangibles, net | 15,957 | 1,663 |
| Other assets | 11,830 | 10,641 |
| Total assets | $ 73,513 | $ 101,821 |
| **LIABILITIES AND SHAREHOLDERS DEFICIT** | | |
| Current liabilities: | | |
| Accounts payable | $ 6,595 | $ 639 |
| Accrued expenses | 26,034 | 28,567 |
| Current portion of deferred revenue | 80 | 80 |
| Current portion of long-term obligations | 1,020 | 2,816 |
| Current portion of derivative liability | | 2,270 |
| Current portion of convertible senior subordinated notes | 16,907 | |
| Current portion of convertible subordinated notes | 2,910 | |
| Total current liabilities | 53,546 | 34,372 |
| Deferred revenue, less current portion | 398 | 478 |
| Long-term obligations, less current portion | 9,879 | 4,667 |
| 7.5% convertible senior notes | 32,220 | 45,916 |
| 6.75% convertible senior notes | 6,922 | 6,945 |
| 5.75% convertible senior notes | 23,287 | |
| Convertible senior subordinated notes | 55,150 | 82,557 |
| Convertible subordinated notes | | 28,490 |
| Total liabilities | 181,402 | 203,425 |
| Commitments and contingencies | | |
| Minority interest in subsidiary | | |
| Preferred stock, no par value: | | |
| Authorized shares 10,000,000 | | |
| Series A 3% Convertible Preferred Stock, $1,000 stated value, 20,000 shares designated; 6,850 and 0 shares issued and outstanding at December 31, 2007 and 2006, respectively | 5,188 | |
| Series B 3% Convertible Preferred Stock, $1,000 stated value, 37,200 shares designated; 15,380 and 0 shares issued and outstanding at December 31, 2007 and 2006, respectively | 11,881 | |
| Series C 3% Convertible Preferred Stock, $1,000 stated value, 20,250 shares designated; 8,284 and 0 shares issued and outstanding at December, 2007 and 2006, respectively | 6,229 | |
| Series D 7% Convertible Preferred Stock, $1,000 stated value, 6,500 shares designated; 4,000 and 0 shares issued and outstanding at December, 2007 and 2006, respectively | 2,938 | |
| Shareholders deficit: | | |
| Common stock, no par value: | | |

| | | |
|---|---|---|
| Authorized shares 100,000,000 | | |
| Issued and outstanding shares 62,444,239 and 36,397,230 at December 31, 2007 and 2006, respectively | 979,295 | 860,691 |
| Accumulated other comprehensive loss | (4,007) | (1,187) |
| Accumulated deficit | (1,109,413) | (961,108) |
| Total shareholders deficit | (134,125) | (101,604) |
| Total liabilities and shareholders deficit | $ 73,513 | $ 101,821 |

See accompanying notes.

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**CELL THERAPEUTICS, INC.**

**CONSOLIDATED STATEMENTS OF OPERATIONS**

**(In thousands, except per share amounts)**

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2007 | 2006 | 2005 |
| Revenues: | | | |
| Product sales | $ 47 | $ | $ 14,599 |
| License and contract revenue | 80 | 80 | 1,493 |
| Total revenues | 127 | 80 | 16,092 |
| Operating expenses: | | | |
| Cost of product sold | 49 | | 518 |
| Research and development | 72,019 | 61,994 | 68,767 |
| Selling, general and administrative | 35,316 | 35,303 | 61,717 |
| Acquired in-process research and development | 24,615 | | |
| Amortization of purchased intangibles | 913 | 792 | 1,254 |
| Restructuring charges and related asset impairments | 201 | 591 | 12,780 |
| Gain on divestiture of TRISENOX | | | (71,211) |
| Total operating expenses | 133,113 | 98,680 | 73,825 |
| Loss from operations | (132,986) | (98,600) | (57,733) |
| Other income (expense): | | | |
| Investment and other income, net | 2,430 | 2,866 | 2,588 |
| Interest expense | (12,517) | (19,829) | (16,546) |
| Foreign exchange gain | 4,657 | 1,877 | 8 |
| Make-whole interest expense | (2,310) | (24,753) | (1,013) |
| Debt conversion expense | | | (23,608) |
| Gain on derivative liabilities | 3,672 | 6,024 | 236 |
| Gain (loss) on exchange of convertible notes | (972) | 7,978 | |
| Settlement expense | (160) | (11,382) | |
| Loss on extinguishment of royalty obligation | | | (6,437) |
| Other expense, net | (5,200) | (37,219) | (44,772) |
| Loss before minority interest | (138,186) | (135,819) | (102,505) |
| Minority interest in net loss of subsidiary | 78 | | |
| Net loss | (138,108) | (135,819) | (102,505) |
| Preferred stock beneficial conversion feature | (9,549) | | |
| Preferred stock dividends | (648) | | |
| Net loss attributable to common shareholders | $ (148,305) | $ (135,819) | $ (102,505) |
| Basic and diluted net loss per common share | $ (3.27) | $ (4.84) | $ (6.35) |
| Shares used in calculation of basic and diluted net loss per common share | 45,292 | 28,070 | 16,138 |

See accompanying notes.

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**CELL THERAPEUTICS, INC.**

**CONSOLIDATED STATEMENTS OF SHAREHOLDERS DEFICIT AND OTHER COMPREHENSIVE LOSS**

**(In thousands)**

| | Common Stock | | Deferred | | Other | Total |
|---|---|---|---|---|---|---|
| | Shares | Amount | Stock-based Compensation | Accumulated Deficit | Comprehensive Income/(Loss) | Shareholders (Deficit) |
| Balance at December 31, 2004 | 15,966 | 652,773 | (2,736) | (722,784) | 2,039 | (70,708) |
| Conversion of convertible senior subordinated notes to common stock | 831 | 39,047 | | | | 39,047 |
| Equity instruments issued to induce conversion of convertible senior subordinated notes to common stock | 845 | 23,608 | | | | 23,608 |
| Issuance of warrants to underwriter of convertible senior notes | | 564 | | | | 564 |
| Conversion of 6.75% convertible senior notes to common stock | 285 | 3,000 | | | | 3,000 |
| Proceeds from stock options exercised and stock sold via employee stock purchase plan | 20 | 238 | | | | 238 |
| Deferred compensation | 410 | 2,186 | (2,186) | | | |
| Amortization of deferred compensation of restricted stock | | | 3,253 | | | 3,253 |
| Equity-based compensation | (1) | (49) | | | | (49) |
| Conversion of restricted share rights to common stock | | 177 | | | | 177 |
| Comprehensive loss: | | | | | | |
| Foreign currency translation loss | | | | | (4,174) | (4,174) |
| Unrealized gains on securities available-for-sale | | | | | 16 | 16 |
| Unrealized gains on interest rate swap | | | | | 436 | 436 |
| Net loss for the year ended December 31, 2005 | | | | (102,505) | | (102,505) |
| Comprehensive loss | | | | | | (106,227) |
| Balance at December 31, 2005 | 18,356 | 721,544 | (1,669) | (825,289) | (1,683) | (107,097) |
| Conversion of 6.75% convertible senior notes to common stock | 6,594 | 69,345 | | | | 69,345 |
| Proceeds from issuance of common stock, net | 5,780 | 37,764 | | | | 37,764 |
| Repurchase of common stock and warrants | (274) | (3,025) | | | | (3,025) |
| Conversion of 7.5% convertible senior notes to common stock | 2,101 | 17,560 | | | | 17,560 |
| Exercise of warrants to common stock | 1,649 | 164 | | | | 164 |
| Proceeds from issuance of common stock to Novartis, net | 2,168 | 14,837 | | | | 14,837 |
| Conversion of convertible senior subordinated notes to common stock | | 4 | | | | 4 |
| Proceeds from stock sold via employee stock purchase plan | 4 | 17 | | | | 17 |
| Deferred compensation | (3) | (1,669) | 1,669 | | | |
| Equity-based compensation | | 4,150 | | | | 4,150 |
| Conversion of restricted share rights to common stock | 22 | | | | | |
| Comprehensive loss: | | | | | | |
| Foreign currency translation gain | | | | | 419 | 419 |
| Realized loss on liquidation of foreign subsidiary | | | | | 41 | 41 |
| Unrealized gains on securities available-for-sale | | | | | 36 | 36 |
| Net loss for the year ended December 31, 2006 | | | | (135,819) | | (135,819) |
| Comprehensive loss | | | | | | (135,323) |
| Balance at December 31, 2006 | 36,397 | $ 860,691 | $ | $ (961,108) | $ (1,187) | $ (101,604) |
| Conversion of convertible preferred stock to common stock | 9,233 | 37,648 | | | | 37,648 |
| Proceeds from issuance of warrants in connection with issuance of convertible preferred stock, net | | 14,526 | | | | 14,526 |
| Value of beneficial conversion feature of preferred stock | | 9,549 | | (9,549) | | |
| Conversion of 7.5% convertible senior notes to common stock | 1,830 | 15,294 | | | | 15,294 |
| Issuance of common stock in connection with SMI acquisition | 4,212 | 19,872 | | | | 19,872 |
| | 5,459 | 13,704 | | | | 13,704 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Issuance of common stock in connection with exchange of 5.75% senior subordinated and subordinated notes | | | | | | |
| Proceeds from issuance of common stock and warrants, net | 3,470 | 6,537 | | | | 6,537 |
| Equity-based compensation | 1,853 | 1,588 | | | | 1,588 |
| Other | (10) | (114) | | | | (114) |
| Dividends on preferred stock | | | | (648) | | (648) |
| Comprehensive loss: | | | | | | |
| Foreign currency translation gain | | | | | (2,807) | (2,807) |
| Unrealized losses on securities available-for-sale | | | | | (13) | (13) |
| Net loss for the year ended December 31, 2007 | | | | (138,108) | | (138,108) |
| Comprehensive loss | | | | | | (140,928) |
| Balance at December 31, 2007 | 62,444 | $ 979,295 | $ | $ (1,109,413) | $ (4,007) | $ (134,125) |

See accompanying notes.

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**CELL THERAPEUTICS, INC.**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(In thousands)**

| | Year Ended December 31, | | |
|---|---|---|---|
| | **2007** | **2006** | **2005** |
| **Operating activities** | | | |
| Net loss | $ (138,108) | $ (135,819) | $ (102,505) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | | |
| Acquired in-process research and development | 24,615 | | |
| Depreciation and amortization | 4,955 | 6,430 | 9,975 |
| Minority interest in net loss of subsidiary | (78) | | |
| Equity-based compensation expense | 1,588 | 4,150 | 3,381 |
| Loss on disposition of property and equipment | 22 | 63 | 157 |
| Amortization (accretion) of investment premium (discount) | (261) | 74 | 303 |
| Non-cash loss (gain) on exchange of convertible notes | 972 | (7,978) | |
| Non-cash gain on derivative liabilities | (3,672) | (6,024) | (236) |
| Non-cash interest expense | 4,280 | 10,977 | 2,930 |
| Non-cash loss on liquidation of subsidiary | | 41 | |
| Asset impairments | | | 3,020 |
| Debt conversion expense | | | 23,608 |
| Gain on divestiture of TRISENOX | | | (71,211) |
| Loss on extinguishment of royalty obligation | | | 6,437 |
| Non-cash rent (benefit) expense | (192) | (15) | 180 |
| Loss (gain) on sale of investment securities | (3) | (1) | 14 |
| Changes in operating assets and liabilities: | | | |
| Restricted cash | | 1,054 | (1,045) |
| Accounts receivable, net | (51) | | |
| Interest receivable | 524 | (383) | (40) |
| Inventory | (290) | | 4 |
| Prepaid expenses and other current assets | 6,431 | 2,283 | 1,077 |
| Other assets | (1,216) | 2,907 | (1,452) |
| Accounts payable | 4,297 | (2,925) | (3,451) |
| Accrued expenses | (4,961) | 11,476 | (5,181) |
| Deferred revenue | (80) | (80) | (1,081) |
| Excess facilities obligations | (2,403) | (2,383) | 6,334 |
| Other long-term obligations | 13 | (453) | 3,550 |
| Total adjustments | 34,490 | 19,213 | (22,727) |
| Net cash used in operating activities | (103,618) | (116,606) | (125,232) |
| **Investing activities** | | | |
| Cash acquired in acquisition of Systems Medicine, Inc., net | 555 | | |
| Cash paid for acquisition of Zevalin | (11,735) | | |
| Net proceeds from divestiture of TRISENOX | | | 70,417 |
| Purchases of securities available-for-sale | (36,463) | (68,905) | (46,827) |
| Proceeds from maturities of securities available-for-sale | 22,442 | 14,665 | 22,693 |
| Proceeds from sales of securities available-for-sale | 48,431 | 36,353 | 15,815 |
| Purchases of property and equipment | (1,753) | (534) | (2,016) |
| Proceeds from sale of property and equipment | | 539 | 253 |
| Net cash provided by (used in) investing activities | 21,477 | (17,882) | 60,335 |

See accompanying notes.

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**CELL THERAPEUTICS, INC.**

**CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)**

**(In thousands)**

| | Year Ended December 31, | | |
|---|---|---|---|
| | **2007** | **2006** | **2005** |
| **Financing activities** | | | |
| Proceeds from issuance of Series A 3% convertible preferred stock and warrants, net | 18,607 | | |
| Proceeds from issuance of Series B 3% convertible preferred stock and warrants, net | 34,836 | | |
| Proceeds from issuance of Series C 3% convertible preferred stock and warrants, net | 18,938 | | |
| Proceeds from issuance of Series D 7% convertible preferred stock and warrants, net | 6,073 | | |
| Proceeds from sale of common stock and warrants, net | 7,007 | | |
| Sale of common stock, net of offering costs | | 37,764 | |
| Repurchase of common stock and warrants | | (3,025) | |
| Proceeds from issuance of 7.5% convertible senior notes, net | | 31,174 | |
| Proceeds from issuance of common stock to Novartis, net | | 14,837 | |
| Proceeds from issuance of 6.75% convertible senior notes, net | | | 77,704 |
| Restricted cash from issuance of 6.75% convertible senior notes, net | | | (24,600) |
| Release of restricted cash related to 6.75% convertible senior notes | | 24,600 | |
| Mandatory redemptions of 6.75% convertible senior notes | | (2,655) | |
| Proceeds from common stock warrants exercised | | 164 | |
| Repayment of royalty obligation | | | (39,388) |
| Payment of dividends on preferred stock | (395) | | |
| Proceeds from common stock options exercised and stock sold via the employee stock purchase plan | | 17 | 238 |
| Proceeds from long-term obligations | 99 | | |
| Repayment of long-term obligations | (429) | (138) | (1,805) |
| Common stock activity related to vesting of equity instruments | (36) | | |
| Net cash provided by financing activities | 84,700 | 102,738 | 12,149 |
| Effect of exchange rate changes on cash and cash equivalents | (3,890) | (1,143) | (2,263) |
| Net decrease in cash and cash equivalents | (1,331) | (32,893) | (55,011) |
| Cash and cash equivalents at beginning of period | 17,129 | 50,022 | 105,033 |
| Cash and cash equivalents at end of period | $ 15,798 | $ 17,129 | $ 50,022 |
| **Supplemental disclosure of cash flow information** | | | |
| Cash paid during the period for interest | $ 10,759 | $ 34,177 | $ 12,640 |
| Cash paid for taxes | $ | $ | $ |
| **Supplemental disclosure of noncash financing and investing activities** | | | |
| Issuance of common stock for acquisition of Systems Medicine, Inc. | $ 19,872 | $ | $ |
| Conversion of series A 3% convertible preferred stock to common stock | $ 9,959 | $ | $ |
| Conversion of series B 3% convertible preferred stock to common stock | $ 16,855 | $ | $ |
| Conversion of series C 3% convertible preferred stock to common stock | $ 8,998 | $ | $ |
| Conversion of series D 7% convertible preferred stock to common stock | $ 1,836 | $ | $ |
| Conversion of 6.75% convertible senior notes to common stock | $ | $ 69,345 | $ 3,000 |
| Conversion of 7.5% convertible senior notes to common stock | $ 15,294 | $ 17,560 | $ |

| | | | |
|---|---|---|---|
| Conversion of convertible senior subordinated notes to common stock, including accrued interest | $ | $ 4 | $ 39,047 |
| Issuance of warrants to underwriter of convertible senior notes | $ | $ | $ 564 |
| Extinguishment of 5.75% convertible senior subordinated notes in exchange for 7.5% convertible senior notes | $ | $ 39,518 | $ |
| Extinguishment of 5.75% convertible subordinated notes in exchange for 7.5% convertible senior notes | $ | $ 1,150 | $ |
| Issuance of 7.5% convertible senior notes in exchange for 5.75% subordinated and senior subordinated notes | $ | $ 33,156 | $ |
| Extinguishment of 5.75% convertible senior subordinated notes in exchange for 5.75% convertible senior notes and common stock | $ 10,500 | $ | $ |
| Extinguishment of 5.75% convertible subordinated notes in exchange for 5.75% convertible senior notes and common stock | $ 25,580 | $ | $ |
| Issuance of 5.75% convertible senior notes in exchange for 5.75% convertible senior subordinated and convertible subordinated notes | $ 23,250 | $ | $ |
| Issuance of common stock in exchange for 5.75% convertible senior subordinated and convertible subordinated notes | $ 13,704 | $ | $ |

See accompanying notes.

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2007**

**1. Description of Business and Summary of Significant Accounting Policies**

*Description of Business*

Cell Therapeutics, Inc., or CTI or the Company, focuses on the development, acquisition and commercialization of drugs for the treatment of cancer. Our principal business strategy is focused on cancer therapeutics, an area with significant market opportunity that we believe is not adequately served by existing therapies. Our operations are primarily conducted in the United States and Italy.

We operate in a highly regulated and competitive environment. The manufacturing and marketing of pharmaceutical products require approval from, and are subject to, ongoing oversight by the Food and Drug Administration, or FDA, in the United States, by the European Agency for Evaluation of Medicinal Products, or EMEA, in Europe and by comparable agencies in other countries. Obtaining approval for a new therapeutic product is never certain and may take many years and involve expenditure of substantial resources.

In December 2007, we completed our acquisition of the U.S. development, sales and marketing rights to the radiopharmaceutical product Zevalin® (Ibritumomab Tiuxetan), or Zevalin, from Biogen Idec Inc., or Biogen, pursuant to an Asset Purchase Agreement. Zevalin was the first FDA-approved radioimmunotherapy and was approved in 2002 to treat patients with relapsed or refractory low-grade, follicular, or B-cell non-Hodgkin s lymphoma, or NHL.

In addition, in July 2007, we completed our acquisition of Systems Medicine, Inc., or SM, a privately held oncology company, in a stock for stock merger. SM holds worldwide rights to use, develop, import and export brostallicin, a synthetic DNA minor groove binding agent that has demonstrated anti-tumor activity and a favorable safety profile in clinical trials in which more than 200 patients have been treated to date.

*Principles of Consolidation*

The consolidated financial statements include the accounts of Cell Therapeutics, Inc. and its wholly owned subsidiaries which include CTI Corporate Development, Inc., SM (from the date of acquisition on July 31, 2007), and CTI Technologies, Inc., which was liquidated in the fourth quarter of 2007. In addition, Cell Therapeutics Inc. Sede Secondaria, or CTI (Europe), was merged into Cell Therapeutics, Inc. on November 30, 2007 and now operates as a branch of the Company. Cell Therapeutics (Ireland) Holding Limited was liquidated in the fourth quarter of 2006 and the Company s wholly owned subsidiaries, Cell Therapeutics (UK) Limited and PolaRx Biopharmaceuticals, Inc., or PolaRx, were sold to Cephalon in connection with the divestiture of TRISENOX in July 2005.

As of December 31, 2007, the Company also has a 69% interest in its majority owned subsidiary, Aequus Biopharma, Inc. Stock ownership by outside and related parties in Aequus Biopharma, Inc. is recorded as *minority interest in subsidiary* and stated net after allocation of losses in the subsidiary.

All intercompany transactions and balances are eliminated in consolidation.

*Reverse Stock-Split*

On April 15, 2007, we effected a one-for-four reverse stock split of our common stock. All impacted amounts included in the consolidated financial statements and notes thereto have been retroactively adjusted for the stock split. Impacted amounts include shares of common stock authorized and outstanding, share issuances, shares underlying stock options and warrants, shares reserved and loss per share.

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*Liquidity*

Our accompanying consolidated financial statements have been prepared assuming that we will continue as a going concern, which contemplates realization of assets and the satisfaction of liabilities in the normal course of business for the twelve month period following the date of these financials. However, we have incurred losses since inception and we expect to generate losses from operations for at least the next couple of years primarily due to research and development costs for Zevalin, paclitaxel poliglumex, pixantrone, and brostallicin. Our available *cash and cash equivalents, securities available-for-sale* and *interest receivable* are approximately $18.4 million as of December 31, 2007. In addition, we raised approximately $1.3 million in gross proceeds from an equity offering under our Step-Up Equity Financing Agreement with Société Générale in January 2008 and approximately $35.5 million in proceeds from a convertible debt offering, net of an inducement payment for conversions of convertible preferred stock, in March 2008. Approximately $13.9 million of the net proceeds received from our convertible debt offering is restricted and is being held in escrow to fund potential make-whole payments due upon conversions of this debt. These amounts are not sufficient to fund our planned operations for the next twelve months as well as repay approximately $10.7 million in principal due on our convertible subordinated and senior subordinated notes in June 2008 which raises substantial doubt about our ability to continue as a going concern. Accordingly, we have commenced a cost savings initiative but will also need to raise additional funds and are currently exploring alternative sources of equity or debt financing. We have a 60 million (approximately $88 million as of December 31, 2007) Step-Up Equity Financing Agreement with Société Générale, of which approximately 59.1 million is available as of March 19, 2008. While we may be able to utilize this agreement to provide additional equity funding, additional funding may not be available on favorable terms or at all. If additional funds are raised by issuing equity securities, substantial dilution to existing shareholders may result. If we fail to obtain additional capital when needed, we may be required to delay, scale back, or eliminate some or all of our research and development programs. The accompanying consolidated financial statements do not include any adjustments that may result from the outcome of this uncertainty.

*Use of Estimates*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. For example, estimates include assumptions used in calculating stock compensation expense, our allocation of purchase price to acquired assets and liabilities, our liability for excess facilities, the useful lives of fixed assets, the fair value of our derivatives, calculating our tax provision and related valuation allowance, determining potential impairment of goodwill and other intangible assets, our sales return reserve and any inventory obsolescence reserve. Actual results could differ from those estimates.

*Cash and Cash Equivalents*

We consider all highly liquid debt instruments with maturities of three months or less at the time acquired to be cash equivalents. Cash equivalents represent short-term investments consisting of investment-grade corporate and government obligations, carried at cost, which approximates market value.

*Securities Available-for-Sale*

We determine the appropriate classification of debt securities at the time of purchase. We currently classify our investment portfolio as available-for-sale which consists of U.S. government, municipal and corporate obligations with maturities of up to one year and carries the securities at fair value based on quoted market prices with unrealized gains and losses included in accumulated other comprehensive loss. The amortized cost of debt securities in this category is adjusted for amortization of premiums and accretion of discounts to maturity. Interest on securities available-for-sale and amortization and accretion of premiums and discounts are included in

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

investment income. Realized gains and losses and declines in value judged to be other-than-temporary on available-for-sale securities, if any, are included in investment income. The cost of securities sold is based on the specific identification method.

*Certain Risks and Concentrations*

We are exposed to risks associated with foreign currency transactions to use U.S. dollars to make contract payments denominated in euros or vice versa. As the net positions of our unhedged foreign currency transactions fluctuate, our earnings might be negatively affected. In addition, we are exposed to risks associated with the translation of euro-denominated financial results and amounts into U.S. dollars. We currently do not utilize forward exchange contracts or any type of hedging instruments to hedge foreign exchange risk as we believe our overall exposure is relatively limited.

We are subject to concentration of credit risk primarily from our cash investments. Under our investment guidelines, credit risk is managed by diversification of the investment portfolio and by the purchase of investment-grade securities. We do not require collateral or other security to support credit sales, but provide an allowance for bad debts when warranted.

If we are unable to obtain sufficient quantities of needed starting materials for the manufacture of our products in development from existing suppliers, or if we were unable to source these materials and services from other suppliers and manufacturers, certain research and development and sales activities may be delayed.

We are exposed to certain labor risks related to our European employees, who represent approximately 31% of our total employees as of December 31, 2007, and who are subject to a collective bargaining agreement as well as to local regulations governing employment.

Additionally, see Note 15, *Customer and Geographic Concentrations*, for further concentration disclosure.

*Product Sales*

We recognize revenue from product sales when there is persuasive evidence that an arrangement exists, title has passed and delivery has occurred, the price is fixed and determinable, and collectability is reasonably assured. Product sales are generally recorded upon shipment net of an allowance for estimated product returns and rebates. We analyze historical return patterns for our products in determining an appropriate estimate for returns allowance. We may need to adjust our estimates if actual results vary which could have an impact on our earnings in the period of adjustment. If customers have product acceptance rights or product return rights, and we are unable to reasonably estimate returns related to that customer or market, we defer revenue recognition until such rights have expired. Our 2007 product sales relate to Zevalin which was acquired from Biogen in December 2007. Our 2005 product sales relate to TRISENOX which was sold to Cephalon in July 2005.

*License and Contract Revenues*

We may generate revenue from technology licenses, collaborative research and development arrangements, cost reimbursement contracts and research grants. Revenue under technology licenses and collaborative agreements typically consists of nonrefundable and/or guaranteed technology license fees, collaborative research funding, and various milestone and future product royalty or profit-sharing payments.

Revenue associated with up-front license fees and research and development funding payments under collaborative agreements is recognized ratably over the relevant periods specified in the agreement, generally the

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

research and development period. If the time period is not defined in the agreement, we calculate the revenue recognition period based on our current estimate of the research and development period considering experience with similar projects, level of effort and the stage of development. Should there be a change in our estimate of the research and development period, we will revise the term over which the initial payment is recognized. Revenue from substantive at-risk milestones and future product royalties is recognized as earned based on the completion of the milestones and product sales, as defined in the respective agreements. Revenue under cost reimbursement contracts and research grants is recognized as the related costs are incurred. Payments received in advance of recognition as revenue are recorded as deferred revenue.

We evaluate multiple element arrangements pursuant to Emerging Issues Task Force, or EITF, 00-21, *Revenue Arrangements with Multiple Deliverables* for multiple element arrangements that have continuing performance obligations, we recognize contract, milestone or license fees together with any up-front payments over the term of the arrangement as we complete our performance obligation, unless the delivered technology has stand alone value to the customer and there is objective, reliable evidence of fair value of the undelivered element in the arrangement. Additionally, pursuant to the guidance of Securities and Exchange Commission Staff Accounting Bulletin 104, or SAB 104, unless evidence suggests otherwise, revenue from consideration received is recognized on a straight-line basis over the expected term of the arrangement.

*Cost of Product Sold*

Cost of product sold consists of the cost of the product sold to our customers, including any necessary allowances for excess inventory that may expire and become unsaleable. Contractual royalties based on product sales, inventory management fees and shipping and handling costs are also included in cost of product sold.

*Inventory*

Inventory is stated at the lower of cost or market. If the cost of the inventory exceeds the expected market value, provisions are recorded for the difference between the cost and the net realizable value. When required, an allowance for excess inventory that may expire and become unsaleable is recorded. All inventory as of December 31, 2007 consists of finished goods inventory for Zevalin.

*Accounts Receivable*

Our accounts receivable balance includes trade receivables related to Zevalin as of December 31, 2007. Allowance for doubtful accounts are based on estimates of losses related to customer receivable balances. We estimate the allowance based upon the age of the outstanding receivables and our historical experience of collections, adjusting for risk of loss for specific customer accounts. We periodically review the estimation process and make changes to the estimates as necessary. When it is deemed probable that a customer account is uncollectible, that balance is written off against the existing allowance. Allowances for uncollectible accounts receivable and product returns, which are offset against our accounts receivable balance, totaled approximately $1,575 as of December 31, 2007.

*Research and Development Expenses*

Research and development expenses include related salaries and benefits, clinical trial and related manufacturing costs, contract and other outside service fees, and facilities and overhead costs related to our research and development efforts. Research and development expenses also consist of costs incurred for proprietary and collaboration research and development and include activities such as product registries and

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

investigator-sponsored trials. Research and development costs are expensed as incurred. Generally, in instances where we enter into agreements with third parties for research and development activities, costs are expensed upon the earlier of when non-refundable amounts are due or as services are performed unless there is an alternative future use of the funds in other research and development projects. Amounts due under such arrangements may be either fixed fee or fee for service, and may include upfront payments, monthly payments, and payments upon the completion of milestones or receipt of deliverables.

*Acquired in-process research and development*

Costs to acquire in-process research and development, or IPRD, projects and technologies which have no alternative future use and which have not reached technological feasibility as of acquisition date are expensed as incurred.

*Value Added Tax Receivable*

Our European operations are subject to Value Added Tax, or VAT, which is usually applied to all goods and services purchased and sold throughout Europe. The VAT receivable is approximately $7.2 million and $10.6 million as of December 31, 2007 and December 31, 2006, respectively, of which $6.5 million and $5.5 million is included in *other assets* and $0.7 million and $5.1 million is included in *prepaid expenses and other current assets* as of December 31, 2007 and December 31, 2006, respectively. This receivable balance relates to our Italian operations and typically has a three year collection period. We review our VAT receivable balance for impairment whenever events or changes in circumstances indicate the carrying amount might not be recoverable.

*Property and Equipment*

Property and equipment are carried at cost, less accumulated depreciation and amortization. Depreciation commences at the time assets are placed in service. It is calculated using the straight-line method over the estimated useful lives of the assets ranging from three to five years for assets other than leasehold improvements which are amortized over the lesser of their useful life of 10 years or the term of the applicable lease using the straight-line method.

*Impairment of Long-lived Assets*

We review our long-lived assets for impairment whenever events or changes in business circumstances indicate that the carrying amount of assets may not be fully recoverable or that the useful lives of these assets are no longer appropriate. Each impairment test is based on a comparison of the undiscounted future cash flows to the recorded value of the asset. If an impairment is indicated, the asset is written down to its estimated fair value based on quoted fair market values. During 2005 we recorded a charge of approximately $1.0 million for asset impairments associated with our restructuring activities (see Note 11, *Restructuring Activities*).

*Goodwill and Other Intangible Assets*

Goodwill is not amortized but is tested for impairment at least annually, or more frequently if indicators of impairment are present. If goodwill is impaired it is written down; however, no impairment of goodwill has been found to date.

There were no changes in the net carrying amount of goodwill during the years ended December 31, 2007, 2006 and 2005.

Other intangible assets consist of acquisition-related intangible assets. These other intangible assets have finite lives and are carried at cost less accumulated amortization.

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Other intangible assets are composed of the following as of December 31 (in thousands):

| | 2007 | | |
|---|---|---|---|
| | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount |
| Developed and core technologies | $ 11,306 | $ (28) | $ 11,278 |
| Manufacturing intangible asset | 3,712 | (16) | 3,696 |
| Assembled workforce | 5,699 | (4,716) | 983 |
| Other intangibles assets | $ 20,717 | $ (4,760) | $ 15,957 |

| | 2006 | | |
|---|---|---|---|
| | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount |
| Assembled workforce | $ 5,088 | $ (3,425) | $ 1,663 |

The change in the value of other intangible assets is as follows:

| | Developed and Core Technologies | Manufacturing Intangible Asset | Assembled Workforce |
|---|---|---|---|
| Balance as of January 1, 2005 | $ | $ | $ 4,175 |
| Impairment | | | (232) |
| Amortization | | | (1,254) |
| Decrease due to exchange rate | | | (450) |
| Balance as of December 31, 2005 | | | 2,239 |
| Amortization | | | (792) |
| Increase due to exchange rate | | | 216 |
| Balance as of December 31, 2006 | | | 1,663 |
| Increase due to acquisitions | 11,306 | 3,712 | 68 |
| Amortization | (28) | (16) | (869) |
| Increase due to exchange rate | | | 121 |
| Balance as of December 31, 2007 | $ 11,278 | $ 3,696 | $ 983 |

Amortization of the assembled workforce intangible asset is computed using the straight-line method over the estimated useful life of the assembled workforce asset, which is approximately 5 years. In 2005, *restructuring charges and related asset impairments* included an impairment charge of $0.2 million due to the termination of certain Italian employees included in the original valuation of this asset. We expect amortization expense on assembled workforce to be approximately $0.9 million for 2008, $14,000 from 2009 to 2011, and $8,000 for 2012.

In 2007, we recorded certain intangible assets in connection with the acquisition of Zevalin. Developed and core technologies are amortized over the terms of the patents related to such technologies of approximately 11.2 years based on a method of amortization that reflects the pattern in which the economic benefit of the intangibles are consumed in accordance with SFAS No. 42, *Goodwill and Other Intangible Assets*. The expected amortization for each of the five succeeding years is approximately $0.1 million in 2008, and $1.0 million for each of the years from 2009 to 2012. The manufacturing intangible asset is amortized straight-line over the term of the supply agreement, which is approximately 6.5 years. The expected amortization on the agreement is

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

approximately $0.6 million for each of the years from 2008 to 2012. We also review our intangible assets for impairment when events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. If future events or circumstances indicate that the carrying value of these assets may not be recoverable, we may be required to record additional charges to our results of operations.

*Royalty Obligation*

Our royalty obligation to PharmaBio Development, or PharmaBio, was recorded as debt as we had significant continuing involvement in the generation of cash flows due to PharmaBio. The obligation was accreted using the effective interest method and an imputed interest rate that was based on our estimates of total royalty and interest payments due under the arrangement. The amount of royalty and interest payments varied depending on whether we reached certain TRISENOX targets and certain other factors as described in the agreement. We reassessed the imputed interest rate as circumstances changed. We extinguished the royalty obligation in July 2005.

*Stock-Based Compensation*

On January 1, 2006, we adopted Financial Accounting Standards Board, or FASB, Statement No. 123(R), *Share-Based Payment (Revised 2004)*, or SFAS 123(R), which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors including employee stock options, share awards, and employee stock purchases related to the Employee Stock Purchase Plan based on estimated fair values. Prior to January 1, 2006, we accounted for share-based payments under the recognition and measurement provisions of Accounting Principles Board, or APB, Opinion No. 25, *Accounting for Stock Issued to Employees*, or APB 25, and related interpretations, as permitted by FASB Statement No. 123, *Accounting for Stock-Based Compensation*, or SFAS 123. In accordance with APB 25, no compensation cost was required to be recognized for options granted that had an exercise price equal to the market value of the underlying common stock on the date of grant. We adopted SFAS 123(R) using the modified-prospective transition method, which required the application of the accounting standard as of January 1, 2006, the first day of our fiscal year 2006.

Under SFAS 123(R), stock-based compensation expense recognized is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Based on this, our stock-based compensation is reduced for estimated forfeitures at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In our pro forma information required under SFAS 123 for the periods prior to January 1, 2006, we accounted for forfeitures as they occurred.

Stock compensation expense for options granted to non-employees has been determined in accordance with SFAS 123(R) and EITF Issue No. 96-18, *Accounting for Equity Instruments that are Issued to Other than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*, at the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measured. The fair value of options granted to non-employees is periodically remeasured as the underlying options vest.

*Advertising Costs*

The costs of advertising are expensed as incurred. We incurred advertising costs of $0.6 million, $0.4 million and $1.8 million in 2007, 2006, and 2005 respectively.

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*Net Loss per Share*

Basic net loss per share is calculated based on the net loss divided by the weighted average number of shares outstanding for the period excluding any dilutive effects of options, warrants, unvested restricted stock awards and convertible securities. Diluted earnings per share assumes the conversion of all dilutive convertible securities, such as convertible subordinated debt using the if-converted method, and assumes the exercise or vesting of other dilutive securities, such as options, warrants and restricted stock using the treasury stock method.

*Derivatives Embedded in Certain Debt Securities*

We evaluate financial instruments for freestanding or embedded derivatives in accordance with SFAS, No. 133, *Accounting for Derivative Instruments and Hedging Activities*, or SFAS 133, and related guidance. Derivative instruments are recorded at fair value with changes in value recognized in the period of change.

Our 6.75% convertible senior notes, or 6.75% notes, contain a feature that provides for a make-whole payment upon any conversion of these notes. The payment is equal to the interest on the debt over its term less any amounts paid prior to the date of the conversion. This make-whole feature represents an embedded derivative which is required to be accounted for separately from the related debt securities. The fair value of this derivative is calculated based on a discounted cash flow model.

Our 7.5% convertible senior notes, or 7.5% notes, include a feature that calls for make-whole payments in the event of automatic conversion or if the holder requires us to repurchase the notes upon certain non-stock changes in control. This payment is equal to $225 per $1,000 principal amount of the notes less any interest amounts paid prior to the date of conversion or repurchase. This make-whole feature also represents an embedded derivative that must be accounted for separately from the related debt securities. The fair value of this derivative is calculated using a Monte Carlo simulation model that incorporates factors such as the current price of our common stock, its volatility, and time to expiration of the make-whole feature. As of December 31, 2006 we determined that we would make additional discretionary make-whole payments to certain investors during 2007. These additional payments constituted modifications to the terms of the agreement and have been included in the valuation model as of December 31, 2006. All additional planned discretionary make-whole payments were made during the three months ended March 31, 2007.

Changes in the estimated fair value of the derivative liabilities related to both our 6.75% and 7.5% notes are included in *gain on derivative liabilities* and will be calculated until the relevant feature expires or all of the relevant notes are converted or repurchased.

The interest make-whole provision of the 5.75% convertible senior notes represents an embedded derivative. At the issuance of the 5.75% notes, no value was assigned to the fair value of the interest make-whole feature.

*Other Financial Instruments*

At December 31, 2007 and 2006, the carrying value of financial instruments such as receivables and payables approximated their fair values based on the short-term maturities of these instruments. The carrying value of other long-term liabilities approximated fair values because the underlying interest rates approximate market rates at the balance sheet dates.

The estimated fair values of our convertible preferred stock, convertible senior notes, convertible senior subordinated notes and convertible subordinated notes are determined using either discounted cash flow modeling techniques or, where practical, estimated trading prices. The carrying values of the respective notes are net of accretion of debt discount and changes in the fair value of derivative liabilities, if any.

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The estimated fair values of our convertible senior notes, convertible senior subordinated notes, convertible subordinated notes and convertible preferred stock are determined using either discounted cash flow modeling techniques or, where practical, estimated trading prices. The carrying values of our convertible notes are net of accretion of debt discount and changes in the fair value of derivative liabilities, if any. The carrying values of our convertible preferred stock are net of issuance costs and the proceeds which were allocated to stock warrants based on a relative market value approach.

The following is a summary of the estimated fair value of our convertible senior notes, convertible senior subordinated notes and convertible subordinated notes as of December 31, 2007 and 2006 (in thousands):

| | December 31, | |
|---|---|---|
| | **2007** | **2006** |
| 7.5% convertible senior notes | $ 29,756 | $ 42,780 |
| 5.75% convertible senior notes | $ 26,650 | $ |
| 6.75% convertible senior notes | $ 6,100 | $ 6,549 |
| 4.0% convertible senior subordinated notes | $ 45,403 | $ 34,193 |
| 5.75% convertible senior subordinated | $ 16,907 | $ 20,555 |
| 5.75% convertible subordinated notes | $ 2,910 | $ 19,373 |

The estimated fair value of our convertible preferred stock as of December 31, 2007 is as follows (in thousands):

| | December 31, 2007 |
|---|---|
| Series A 3% convertible preferred stock | $ 6,231 |
| Series B 3% convertible preferred stock | $ 13,799 |
| Series C 3% convertible preferred stock | $ 7,744 |
| Series D 7% convertible preferred stock | $ 4,195 |

*Foreign Currency Translation and Transaction Gains and Losses*

We record foreign currency translation adjustments and transaction gains and losses in accordance with SFAS 52, *Foreign Currency Translation.* For our operations that have a functional currency other than the U.S. dollar, gains and losses resulting from the translation of the functional currency into U.S. dollars for financial statement presentation are not included in determining net loss but are accumulated in the cumulative foreign currency translation adjustment account as a separate component of shareholders deficit. The Company and its subsidiaries also have transactions in foreign currencies other than the functional currency. We record transaction gains and losses in our consolidated statements of income related to the recurring measurement and settlement of such transactions.

*Comprehensive Loss*

Comprehensive loss is comprised of net loss and other comprehensive income or loss. SFAS 130, *Reporting Comprehensive Income*, provides for unrealized gains and losses on our securities available-for-sale and net exchange gains or losses resulting from the translation of assets and liabilities of foreign subsidiaries to be included in other comprehensive income or loss. Total comprehensive loss was $140.9 million, $135.3 million and $106.2 million as of December 31, 2007, 2006 and 2005, respectively.

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Information regarding the components of accumulated other comprehensive loss is as follows (in thousands):

| | 2007 | 2006 |
|---|---|---|
| Foreign currency translation adjustment | $ (4,010) | $ (1,203) |
| Net unrealized gain on securities available-for-sale | 3 | 16 |
| Total other accumulated comprehensive loss | $ (4,007) | $ (1,187) |

*Recently Issued Accounting Pronouncements*

On December 4, 2007, Statement of Financial Standard No. 141(R), *Business Combinations,* or SFAS 141(R), was issued. This standard will require 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 as an indefinite lived intangible asset and either amortize it over the life of the product, or write it off if the project is abandoned or impaired. The acquiring company will be required to expense the acquisition costs rather than be added to the cost of the acquisition. The standard is effective for transactions occurring on or after January 1, 2009. We are evaluating the impact this standard will have on our financial statements.

On December 4, 2007, Statement of Financial Standard No. 160, *Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51*, or SFAS 160, was issued. This standard changes the accounting for and reporting of noncontrolling or minority interests in consolidated financial statements. The standard is effective January 1, 2009, however the presentation and disclosure requirements of SFAS 160 regarding noncontrolling interests shall be applied retrospectively. We are evaluating the impact, if any, this standard will have on our financial statements.

In November 2007, the EITF reached a consensus on Issue 07-1. EITF 07-1, *Accounting for Collaborative Arrangements Related to the Development and Commercialization of Intellectual Property*, is focused on how the parties to a collaborative agreement should account for costs incurred and revenue generated on sales to third parties, how sharing payments pursuant to a collaborative agreement should be presented in the income statement and certain related disclosure questions. EITF 07-1 is effective for periods beginning after December 15, 2008. We are evaluating the requirements of these issues and have not yet determined the impact on the financial statements.

In June 2007, the EITF reached a consensus on Issue 07-3, *Accounting for Nonrefundable Advance Payments for Goods or Services to Be Used in Future Research and Development Activities,* or EITF 07-3, which focuses on whether non-refundable advance payments for goods or services that will be performed in future research and development activities should be accounted for as research and development costs or deferred and capitalized until the goods have been delivered or the related services have been rendered. EITF 07-3 is effective for periods beginning after December 15, 2007. We are evaluating the impact, if any, this EITF will have on our financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115*, or SFAS 159. The Statement permits entities to choose, at specified election dates, to measure many financial instruments and certain other items at fair value that are not currently measured at fair value. Unrealized gains and losses on items for which the fair value option has been elected would be reported in earnings at each subsequent reporting date. SFAS 159 also establishes presentation and disclosure requirements in order to facilitate comparisons between entities

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

choosing different measurement attributes for similar types of assets and liabilities. SFAS 159 does not affect existing accounting requirements for certain assets and liabilities to be carried at fair value. SFAS 159 is effective for fiscal years beginning after November 15, 2007, and adopted by us beginning January 1, 2008. We are evaluating the requirements of SFAS 159 and have not yet determined the impact on the financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, or SFAS 157, which provides guidance on how to measure assets and liabilities that use fair value. This statement clarifies the principle that fair value should be based on the assumptions market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. SFAS 157 will apply whenever another generally accepted accounting principle requires, or permits, assets or liabilities to be measured at fair value but does not expand the use of fair value to any new circumstances. This statement will also require additional disclosures in both annual and quarterly reports. SFAS 157 is effective for fiscal years beginning after November 2007, and adopted by us beginning January 1, 2008. We are evaluating the impact, if any, this standard will have on our financial statements.

*Reclassifications*

Certain prior year items have been reclassified to conform to current year presentation.

**2. Securities Available-for-Sale**

Securities available-for-sale consist of the following debt securities as of December 31 (in thousands):

| | 2007 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| Corporate obligations | $ 1,001 | $ | $ (1) | $ 1,000 |
| Municipal obligations | 799 | 3 | | 802 |
| U.S. government obligations | 745 | 1 | | 746 |
| | $ 2,545 | $ 4 | $ (1) | $ 2,548 |

| | 2006 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| Corporate obligations | $ 22,980 | $ 21 | $ (4) | $ 22,997 |
| Municipal obligations | 7,442 | 2 | (4) | 7,440 |
| U.S. government obligations | 6,270 | 2 | (1) | 6,271 |
| | $ 36,692 | $ 25 | $ (9) | $ 36,708 |

As of December 31, 2007, and 2006, all securities available-for-sale had contractual maturities of less than one year. Gross realized gains and losses to date have not been material.

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**3. Property and Equipment**

Property and equipment are composed of the following as of December 31 (in thousands):

| | 2007 | 2006 |
|---|---|---|
| Leasehold improvements | $ 11,644 | $ 11,208 |
| Lab equipment | 7,452 | 6,311 |
| Furniture and office equipment | 18,300 | 17,878 |
| | 37,396 | 35,397 |
| Less: accumulated depreciation and amortization | (31,371) | (27,482) |
| | $ 6,025 | $ 7,915 |

Depreciation expense of $4.1 million, $5.6 million and $8.9 million was recognized during 2007, 2006, and 2005, respectively. We also recorded fixed asset impairments of $0.8 million during 2005 related to our restructuring activities.

**4. Accrued Liabilities**

Accrued liabilities consist of the following as of December 31 (in thousands):

| | 2007 | 2006 |
|---|---|---|
| Clinical development and regulatory expense | $ 11,936 | $ 8,855 |
| USAO litigation claim (see note 19, *Legal Proceedings*) | | 10,500 |
| Employee compensation and related expenses | 4,738 | 4,261 |
| Manufacturing expense | 2,319 | 1,286 |
| Corporate development and sales and marketing expense | 1,924 | 911 |
| Insurance financing and accrued interest expense | 689 | 917 |
| Other research and development expenses | 464 | 241 |
| Other | 3,964 | 1,596 |
| | $ 26,034 | $ 28,567 |

**5. Contractual Arrangements and Commitments**

*Lease Agreements*

*Facilities*

We lease our office and laboratory space under operating leases. Leases for our corporate office space contain an annual escalation clause of approximately 3% and the related rent expense is recognized on a straight-line basis over the term of the respective lease. In connection with a lease agreement, we have a $0.7 million irrevocable, unconditional standby letter of credit which is secured by a certificate of deposit classified in our consolidated balance sheet in *other assets* as of December 31, 2007 and 2006. Rent expense amounted to approximately $4.0 million, $3.8

million and $7.3 million for the years ended December 31, 2007, 2006 and 2005, respectively. Rent expense is net of sublease income and amounts offset to excess facilities charges (see Note 11, Restructuring Activities).

During 2004 through 2007, we entered into sublease agreements to sublet a portion of our facilities considered to be in excess of current requirements. Total sublease rental income for fiscal years 2007, 2006 and

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

2005 was $1.0 million, $0.9 million and $0.2 million, respectively, recorded as an offset to lease expense. Total future sublease income to be recognized is approximately $0.1 million for 2008 at which time the term of our existing subleases expires.

*Aircraft*

In 2005, we terminated an aircraft operating lease agreement. Rent expense under the lease amounted to $1.9 million for the year ended December 31, 2005. In 2005 we also made a $1.2 million payment in connection with the early termination of the lease which is included in *restructuring charges and related asset impairments*.

*Capital Leases*

We have two capital lease agreements related to our European branch to finance lab equipment. One of these capital leases has a rate of 5.1% and terminates in February 2008 and the other has a rate of 6.0% and terminates in May 2010. The gross amount of assets under capital lease obligations was approximately $0.8 million as of December 31, 2007 and 2006, respectively. The related accumulated depreciation was approximately $0.4 million and $0.3 million as of December 31, 2007 and 2006, respectively.

*Future Minimum Lease Payments*

Future minimum lease commitments for noncancelable operating and capital leases at December 31, 2007 are as follows (in thousands):

| | Capital Leases | Operating Leases |
|---|---|---|
| 2008 | $ 73 | $ 6,352 |
| 2009 | 19 | 6,042 |
| 2010 | 9 | 5,991 |
| 2011 | | 5,899 |
| 2012 | | 4,269 |
| Thereafter | | 968 |
| Total minimum lease commitments | $ 101 | $ 29,521 |
| Less interest | (4) | |
| Present value of lease obligation | 97 | |
| Less current portion of long-term obligation | (73) | |
| Long-term obligation | $ 24 | |

As of December 31, 2007, 2006 and 2005, we had a liability of approximately $1.5 million, $4.0 million and $6.3 million, respectively, in charges for excess facilities under our current operating leases in accordance with SFAS 146. These charges included lease commitments, net of estimated sublease income (see Note 11, *Restructuring Activities*).

*Supply Agreements*

*Zevalin*

In December 2007, in connection with our acquisition of Zevalin, we entered into a seventy-eight month supply agreement with Biogen to manufacture Zevalin for sale in the United States pursuant to which we will purchase from Biogen, and Biogen will provide to us, kits to make single doses as part of one treatment to a patient, of either (i) Indium-111 Ibritumomab Tiuxetan (In-111 Zevalin) or (ii) Yttrium-90 Ibritumomab Tiuxetan (Y-90 Zevalin) either as single kits or in packages containing one dose of each of In-111 Zevalin and Y-90 Zevalin, each

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

for sale to end-users in the United States at a cost plus manufacturing price. From the effective date of the supply agreement through June 9, 2014, unless earlier terminated, we have agreed to purchase such kits and/or packages solely from Biogen unless and until both we and Biogen agree to the establishment of a replacement manufacturing source in accordance with the terms and conditions of the Supply Agreement. Each party has agreed to indemnify the other party from and against certain third-party claims related to the manufacture, sale, distribution or use of the goods, as the case may be. We provide rolling forecasts of our supply requirements to Biogen in six-month increments for the next 30 months; however, under the terms of the agreement we are required to purchase a minimum of 150 packages, or 300 kits, for each six-month period in 2008, 2009 and 2010, and a minimum of 250 packages, or 500 kits, for each six month period thereafter until the expiration of the term. Each forecast for the next six months must be accompanied by a firm order, and we may not place orders more frequently than twice a year.

Future purchase obligations under this agreement are as follows (in thousands):

| | |
|---|---|
| 2008 | $ 958 |
| 2009 | 320 |
| 2010 | 320 |
| 2011 | 532 |
| 2012 | 532 |
| Thereafter | 799 |
| Total purchase obligations | $ 3,461 |

Also in December 2007, in connection with our acquisition of Zevalin, we assumed from Biogen a manufacturing and supply agreement with MDS (Canada) Inc., MDS Nordion Division, or MDS (Canada), pursuant to which MDS (Canada) supplies us with yttrium-90, a radioisotope used in connection with the administration of Zevalin. Under the terms of the agreement, we are required to purchase, and MDS (Canada) is required to manufacture and supply, all of our yttrium-90 requirements for commercial uses of Zevalin. The agreement expires under its current terms in February 2010 and may be terminated by MDS (Canada) at any time without cause on 24 months written notice or by CTI at any time without cause on 6 months written notice.

*Paclitaxel*

In September 2001, we entered into a purchase agreement with Natural Pharmaceuticals, Inc., or NPI, to purchase $6.0 million of paclitaxel, a starting material for paclitaxel poliglumex, which was to be delivered by NPI over several years. This material was intended to be used primarily for research and development activities. We paid for the entire purchase upon execution of the agreement in 2001 and recorded the amount as a prepaid asset. As we had adequate supply of paclitaxel on hand to support our validation campaigns and clinical activities, we amended our supply agreement with NPI in 2005 to reduce the amount of material we would receive and we were refunded $0.8 million of our prepayment. In addition, the agreement, as amended, granted NPI the exclusive right to purchase up to 5 kilograms of our paclitaxel supply at our original cost through September 1, 2007. The amended agreement also allows NPI the right to sell some or all of the paclitaxel supply to its customers and replace the material within 60 days with newer material having a longer expiration date. In August 2007, we entered into an additional amendment whereby NPI repurchased 3.7 kilograms of our prepaid paclitaxel which was currently in NPI s possession. The amount paid by NPI would offset the cost of 5.3 kilograms of new paclitaxel supply that NPI originally agreed to provide us by November 1, 2007. We received a portion of this new paclitaxel supply in December 2007 and the remaining amount is expected to be delivered by April 2008.

As of December 31, 2007 and 2006, we had paclitaxel supply of $0.7 million and $1.1 million, respectively, which is included in *prepaid expenses and other current assets*. The amount as of December 31, 2007 and 2006 includes approximately $0.5 million and $0.4 million in supply due from NPI. These costs have been capitalized

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

since there is a ready market for this active pharmaceutical ingredient. The paclitaxel supply was adjusted during the second quarter of 2005 to reflect a $1.7 million write-down to its estimated re-sale value based on current prices obtained from an external vendor.

**6. Acquisitions**

*Systems Medicine, Inc.*

On July 31, 2007, we completed the acquisition of SM, in a stock for stock merger. Pursuant to the terms of the acquisition, we issued to SM stockholders an aggregate of 4,211,856 shares of our common stock in exchange for outstanding SM common stock. Of the total shares issued, 421,186 remain in an escrow account subject to any claim for indemnification made by us. Upon the one-year anniversary of the closing date, the acquisition agreement provides instructions on the release of the remaining escrowed shares. Under the agreement, SM became Systems Medicine, LLC, and now operates as a wholly owned subsidiary of CTI.

SM s stockholders can also receive a maximum of $15 million in additional consideration (payable in cash or stock at our election, subject to certain Nasdaq limitations on issuance of stock) upon the achievement of certain FDA regulatory milestones. At this time, it is not possible to predict whether these milestones will be achieved; accordingly, the following estimated purchase price does not reflect the payment of this contingent consideration.

The total cost of the acquisition is estimated to be approximately $20.4 million, based on the fair value of our common stock of $4.718, the average price of our common stock during a 5-business day period prior to the date of the acquisition agreement (July 17, 18, 19, 20 and 23, 2007) and related transaction costs, consisting primarily of financial advisory, legal and accounting fees. The total purchase price of the acquisition is as follows (in thousands):

| | |
|---|---|
| Total value of CTI common stock, including escrowed shares | $ 20,000 |
| Direct transaction costs | 499 |
| Total purchase price | $ 20,499 |

Based on the provisions of SFAS No. 141, *Business Combinations*, or SFAS 141, and EITF Issue No. 98-3, *Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business*, or EITF 98-3 we determined the transaction to be an asset acquisition, and accordingly, the total estimated purchase price as shown in the table above was allocated to SM s net tangible and intangible assets, including IPRD, based on their relative fair values as of July 31, 2007, the closing date of the acquisition. The estimated fair value of these assets in excess of the purchase price was then allocated on a pro rata basis to reduce in-process research and development and non-monetary long-lived assets. The allocation of the purchase price as of the date of the acquisition is as follows (in thousands):

| | |
|---|---|
| Cash and cash equivalents | $ 3,100 |
| Prepaid expenses and other current assets | 14 |
| Other receivables | 116 |
| Notes receivable | 99 |
| Property and equipment | 4 |
| Intangible assets | 68 |
| Other non current assets | 2 |
| Accounts payable and accrued expenses | (2,297) |
| Promissory notes | (2,000) |

| | |
|---|---|
| Acquired in-process research and development | 21,393 |
| Total | $ 20,499 |

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Acquired IPRD for the acquisition was evaluated utilizing the present value of the estimated after-tax cash flows expected to be generated by purchased technology related to brostallicin, which, at the effective time of the acquisition, had not reached technological feasibility. Brostallicin is a novel synthetic second-generation DNA minor groove binder that has proven anti-cancer activity and has demonstrated synergy in combination with standard cytotoxic agents as well as with newer targeted therapies in preclinical experimental tumor models. The cash flow projections for future revenues used in the present value calculation of IPRD are based on estimates of growth rates and the aggregate size of the respective market for brostallicin, probability of technical success given the state of development at the time of acquisition, royalty rates based on an assessment of industry market rates, product sales cycles, and the estimated life of a product s underlying technology. These revenue projections include assumptions that significant cash flows from product revenue would commence in 2011. Estimated operating expenses and income taxes are deducted from estimated revenue projections to arrive at estimated after-tax cash flows. Projected operating expenses include cost of goods sold, selling, general and administrative expenses, and research and development costs. The rate utilized to discount projected cash flows was approximately 18%, and was based on the relative risk of the in-process technology and was based primarily on risk adjusted rates of return for similar research and development programs in the industry and the weighted average cost of capital for CTI at the time of the acquisition.

The values associated with this program represent values ascribed by CTI s management, based on the discounted cash flows currently expected from the technology acquired and a pro rata allocation of the estimated fair values of non-monetary assets acquired in excess of the purchase price. The estimated cash flows include the estimated development costs and estimated product launch date with the estimated life of the product ending fourteen years after approval. If the project is not successfully developed, the business, our results of operations and financial condition may be adversely affected. As of the date of the acquisition , we concluded that once completed, the technology under development can only be economically used for the specific and intended purpose and that the in-process technology has no alternative future use after taking into consideration the overall objective of the project, progress toward the objective, and uniqueness of development to this objective. Due to this, all IPRD was expensed on the acquisition date.

*Zevalin*

On December 21, 2007, we acquired the U.S. development, sales and marketing rights to the radiopharmaceutical product Zevalin from Biogen pursuant to an Asset Purchase Agreement. Zevalin is the first FDA-approved radioimmunotherapy and was approved in 2002 to treat patients with relapsed or refractory low-grade, follicular, or B-cell NHL. The assets acquired included the Zevalin FDA registration, FDA dossier, U.S. trademark, trade name and trade dress, customer list, certain patents and the assignment of numerous contracts. The acquisition did not include physical facilities, an employee base, or working capital accounts. Additionally, CTI entered into a seventy-eight month supply agreement with Biogen to manufacture Zevalin for sale in the United States as well as a security agreement providing Biogen a first priority security interest in the assets purchased in the transaction. The purchase consideration consisted of an initial purchase price of $10.1 million in cash and other acquisition costs of approximately $2.0 million, consisting primarily of financial advisory, legal and accounting fees. The direct transaction costs are estimated, pending resolution of certain accruals related to the acquisition. We are also responsible for up to $20 million in contingent milestone payments consisting of two $10 million payments, based on positive trial outcomes and FDA approval for label expansion, or contingent consideration. We believe the likelihood of making one such $10 million payment is remote as we have determined that label expansion for an aggressive NHL indication is remote at this time. To date, no contingent payments have been made. CTI is also obligated to make additional royalty payments based on net sales of Zevalin.

Based on the provisions of SFAS 141, and EITF 98-3, we determined the transaction to be a business combination and was accounted for using the purchase method of accounting. The results of operations of

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Zevalin have been included in our consolidated financial statements effective December 21, 2007. The purchase price was allocated to Zevalin s intangible assets, including IPRD, based on their fair values at the date of acquisition as determined by management. A valuation of the intangible assets was performed by an independent third party, and was used as the basis for management s consideration of these fair values. The total estimated purchase consideration was allocated as follows (in thousands):

| | |
|---|---|
| Core technology | $ 9,755 |
| Developed technology | 1,551 |
| Manufacturing intangible asset | 3,712 |
| Acquired in-process research and development | 3,222 |
| Contingent purchase price | (6,180) |
| Total estimated purchase price | $ 12,060 |

The fair value of the assets acquired exceeded the unconditional consideration paid by approximately $6.2 million. Because the acquisition involved contingent consideration, we were required to recognize additional purchase consideration equal to the lesser of the excess fair value or the maximum amount of contingent consideration of $20 million. Accordingly, contingent consideration totaling approximately $6.2 million has been recorded as a liability, thereby reducing the excess fair value. This amount is included in *long-term obligations, less current portion.*

When the contingency is resolved and the consideration is issued or becomes issuable, any excess of the fair value of the contingent consideration issued or issuable over the amount that was recognized as a liability shall be recognized as an additional cost of the acquired entity. If the amount initially recognized as a liability exceeds the fair value of the consideration issued or issuable, that excess will be allocated as a pro rata reduction of the amounts assigned to the assets acquired. Any amount that remains after reducing those assets to zero will be recognized as an extraordinary gain.

The developed technology asset relates to intellectual property and rights thereon related to Zevalin as approved by the FDA for relapsed or refractory low-grade, follicular, or B-cell NHL. The core technology asset represents the value of the intellectual property and rights thereon expected to be leveraged in the development of label expansions for Zevalin.

Acquired IPRD for the acquisition was evaluated utilizing the present value of the estimated after-tax cash flows expected to be generated by purchased undeveloped technology related to Zevalin for label expansions for indications that have not been approved by the FDA which, at the effective time of the acquisition, had not reached technological feasibility. The cash flow projections for future revenues used in the present value calculation of IPRD are based on estimates of growth rates and the aggregate size of the respective market for Zevalin as it relates to label expansions, the expected annual price per script and the expected discounts, returns and allowances, distribution charges, and rebates per unit. The projections for revenues related to label expansions include assumptions that cash flows from product revenue would commence in 2009. Estimated operating expenses and income taxes are deducted from estimated revenue projections to arrive at estimated after-tax cash flows. Projected operating expenses include cost of goods sold, selling, general and administrative expenses, and research and development costs. The rate utilized to discount projected cash flows was approximately 45%, and was based on the relative risk of the in-process technology and was based primarily on risk adjusted rates of return for research and development and the weighted average cost of capital for CTI at the time of the acquisition.

The value associated with IPRD represents the value ascribed by CTI s management, based on the discounted cash flows under the multi-period excess earnings method currently expected from the technology

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

acquired. The estimated cash flows include the estimated development costs and estimated revenues related to label expansions from the commencement date referred to above with the estimated economic life of the product ending 14 years after its approval for additional indications. If label expansions for Zevalin are not approved by the FDA, the business, our results of operations and financial condition may be adversely affected. As of the date of the acquisition, we concluded that once completed, the technology under development can only be economically used for the specific and intended purpose and that the in-process technology has no alternative future use after taking into consideration the overall objective of the project, progress toward the objective, and uniqueness of development to this objective. Due to this, all IPRD was expensed on the acquisition date.

*Pro forma results of operations (unaudited)*

Our consolidated statements of operations for the year ended December 31, 2007 include SM s results of operations from July 31, 2007 and Zevalin s results of operations from December 21, 2007.

The following table sets forth the pro forma combined results of operations of CTI, SM and Zevalin for the years ended December 31, 2007 and 2006 (in thousands, except per share amounts):

| | Year Ended December 31, (unaudited) | |
|---|---|---|
| | **2007** | **2006** |
| Revenues | $ 13,829 | $ 16,498 |
| Net loss attributable to common shareholders | (159,065) | (160,192) |
| Basic and diluted net loss per common share | $ (3.21) | $ (4.96) |

For pro forma purposes:

CTI s consolidated results of operations for the years ended December 31, 2007 and 2006 have been combined with SM s results of operations and Zevalin s statement of net revenues and direct expenses for the years ended December 31, 2007 and 2006 as if the mergers had occurred on January 1, 2007 and 2006, respectively;

The pro forma results do not include the effect or the charge for IPRD for the year ended December 31, 2006 as this is a non recurring charge resulting from the acquisitions. As our consolidated statement of operations for the year ended December 31, 2007 includes IPRD, for consistency purposes the pro forma amounts above also include IPRD for this period.

The unaudited pro forma combined financial data is intended for information purposes only and does not purport to represent what our results of operations would actually have been if the acquisition had in fact occurred on the dates indicated or to project our financial position or results of operations as of any future date or any future period.

**7. Convertible Preferred Stock**

*Series A 3% Convertible Preferred Stock*

In February 2007, we issued 20,000 shares of our Series A 3% Convertible Preferred Stock, or Series A preferred stock, in a registered offering at an issue price of $1,000 per share with an annual dividend rate of 3%, payable quarterly. The Series A preferred stock is convertible at any time into a number of shares of our common stock determined by dividing the stated value of the preferred stock to be converted, which is $1,000 per share, by the conversion price, which is currently $6.69 following adjustment for our one-for-four reverse stock split on April 15, 2007. The initial conversion price is subject to adjustment in certain events. The Series A preferred stock votes on an as-converted basis with the common stock.

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

In connection with the Series A preferred stock issuance, we issued warrants to purchase an additional 1,494,766 shares of our common stock at an exercise price of $6.44 per share. The warrants became exercisable on April 16, 2007 and will terminate two years after this date.

The holders of Series A preferred stock have the right to require us to redeem all or a portion of the Series A preferred stock shares, payable in common stock, upon the occurrence of certain triggering events, as discussed below, 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 preceding the conversion and (2) the stated value divided by the conversion price; plus all accrued and unpaid dividends or other payments on such shares. In addition, at any time after the two-year anniversary of the original issue date, holders of Series A preferred stock have the right to require us to redeem any of their outstanding Series A preferred stock for cash 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. With respect to our accounting for the preferred stock, because redemption is at the option of the holder of the Series A preferred stock and is not certain to occur, it is considered contingently redeemable and is not classified as a liability under the scope of SFAS 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. In addition, EITF Topic D-98, *Classification and Measurement of Redeemable Securities*, states that Rule 5-02.28 of Regulation S-X requires securities with redemption features that are not solely within the control of the issuer to be recorded outside of permanent equity. As the Series A preferred stock shares include certain redemption features that may be triggered by events or actions that are outside our control, we have classified these shares as mezzanine equity.

The net proceeds from the issuance of the Series A preferred stock of approximately $18.6 million were allocated between the fair value of the warrants and the Series A preferred stock. Using the Black-Scholes option pricing model, we calculated the relative fair value of the warrants to purchase 1,494,766 of our common stock to be approximately $3.5 million. This relative fair value has been recorded as a reduction of the mezzanine equity balance for the preferred stock and an addition to common stock. Additionally, we calculated a beneficial conversion feature charge related to the conversion price for the preferred stock to common stock of approximately $2.6 million. As the preferred stock can be converted immediately, the amount of the beneficial conversion feature was immediately accreted and resulted in a deemed dividend. This charge was recorded as a dividend expense included in *preferred stock beneficial conversion feature* in determining the net loss attributable to common shareholders.

During the year ended December 31, 2007, 13,150 shares of Series A preferred stock were converted into 1,965,619 shares of common stock. As of December 31, 2007, we had approximately $51,000 of Series A preferred stock dividends accrued which were paid in January 2008.

*Series B 3% Convertible Preferred Stock*

In April 2007, we issued 37,200 shares of our Series B 3% convertible preferred stock, or Series B preferred stock, in a registered offering at an issue price of $1,000 per share with an annual dividend rate of 3%, payable quarterly. The Series B preferred stock is convertible at any time into a number of shares of our common stock determined by dividing the stated value of the preferred stock to be converted, which is initially $1,000 per share, by the conversion price, which is initially $6.73. The initial conversion price is subject to adjustment in certain events. The Series B preferred stock votes on an as-converted basis with the common stock.

In connection with the Series B preferred stock issuance, we issued warrants to purchase an additional 2,763,731 shares of our common stock at an exercise price of $6.48 per share. The warrants became exercisable on October 16, 2007 and will terminate two years from this date.

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The holders of Series B preferred stock have the right to require us to redeem all or a portion of the Series B preferred stock shares, payable in common stock, upon the occurrence of certain triggering events, as discussed below, 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 preceding the conversion multiplied by (2) the stated value divided by the conversion price; plus all accrued and unpaid dividends or other payments on such shares. In addition, at any time after the two-year anniversary of the original issue date and subject to the prior rights of the Series A preferred stock, holders of Series B preferred stock have the right to require us to redeem any of their outstanding Series B preferred stock for cash at the stated value plus any accrued but unpaid dividends or other payments due on the shares being redeemed. Based on these redemption features, which are comparable to the redemption features of our other preferred stock, we have classified these shares as mezzanine equity in accordance with the guidance discussed above in the Series A preferred stock.

The net proceeds from the issuance of the Series B preferred stock of approximately $34.8 million were allocated between the fair value of the warrants and the Series B preferred stock. Using the Black-Scholes option pricing model, we calculated the relative fair value of the warrants to purchase 2,763,731 shares of our common stock to be approximately $6.1 million. This relative fair value has been recorded as a reduction of the mezzanine equity balance for the Series B preferred stock and an addition to common stock. Additionally, we calculated a beneficial conversion feature charge related to the conversion price for the Series B preferred stock to common stock of approximately $1.8 million. As the Series B preferred stock can be converted immediately, the amount of the beneficial conversion feature was immediately accreted and resulted in a deemed dividend. This charge was recorded as a dividend expense included in *preferred stock beneficial conversion feature* in determining the net loss attributable to common shareholders.

During the year ended December 31, 2007, 21,820 shares of Series B preferred stock were converted into 3,242,190 shares of common stock. As of December 31, 2007, we had approximately $115,000 of Series B preferred stock dividends accrued which were paid in January 2008.

*Series C 3% Convertible Preferred Stock*

In July 2007, we issued 20,250 shares of our Series C 3% convertible preferred stock, or Series C preferred stock, in a registered offering at an issue price of $1,000 per share with an annual dividend rate of 3%, payable quarterly. The Series C preferred stock is convertible at any time into a number of shares of our common stock determined by dividing the stated value of the preferred stock to be converted, which is initially $1,000 per share, by the conversion price, which is initially $3.90. The initial conversion price is subject to adjustment in certain events. The Series C preferred stock will have the right to the number of votes equal to the stated value, or $1,000 per share, divided by $4.53 in all matters as to which shareholders are required or permitted to vote with the common stock.

In connection with the Series C preferred stock issuance, we issued warrants to purchase an additional 2,596,148 shares of our common stock at an exercise price of $4.53 per share. The warrants will not be exercisable until January 27, 2008 and will terminate on the second anniversary of the date upon which they become exercisable.

The holders of Series C preferred stock have the right to require us to redeem all or a portion of the Series C preferred stock shares, payable in common stock, upon the occurrence of certain triggering events, as discussed below, 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 preceding the conversion multiplied by (2) the stated value divided by the conversion price; plus all accrued and unpaid dividends or other payments on such shares. In addition, at any time after the two-year anniversary of the original issue date and subject to the prior rights of the Series A and B preferred stock, holders of Series C preferred stock have the right to require us

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

to redeem any of their outstanding Series C preferred stock for cash at the stated value plus any accrued but unpaid dividends or other payments due on the shares being redeemed. Based on these redemption features, which are comparable to the redemption features of our other preferred stock, we have classified these shares as mezzanine equity in accordance with the guidance discussed above in the Series A preferred stock.

The net proceeds from the issuance of the Series C preferred stock of approximately $18.9 million were allocated between the fair value of the warrants and the Series C preferred stock. Using the Black-Scholes option pricing model, we calculated the relative fair value of the warrants to purchase 2,596,148 shares of our common stock to be approximately $3.7 million. This relative fair value has been recorded as a reduction of the mezzanine equity balance for the Series C preferred stock and an addition to common stock. Additionally, we calculated a beneficial conversion feature charge related to the conversion price for the Series C preferred stock to common stock of approximately $3.9 million. As the Series C preferred stock can be converted immediately, the amount of the beneficial conversion feature was immediately accreted and resulted in a deemed dividend. This charge was recorded as a dividend expense included in *preferred stock beneficial conversion feature* in determining the net loss attributable to common shareholders.

During the year ended December 31, 2007, 11,966 shares of Series C preferred stock were converted into 3,068,195 shares of common stock. As of December 31, 2007, we had approximately $62,000 of Series C preferred stock dividends accrued which were paid in January 2008.

*Series D 7% Convertible Preferred Stock*

In December 2007, we issued 6,500 shares of our Series D 7% convertible preferred stock, or Series D preferred stock, in a registered offering at an issue price of $1,000 per share with an annual dividend rate of 7%, payable quarterly. The Series D preferred stock is convertible at any time into a number of shares of our common stock determined by dividing the stated value of the preferred stock to be converted, which is initially $1,000 per share, by the conversion price, which is initially $2.6125. The initial conversion price is subject to adjustment in certain events. The Series D preferred stock votes on an as-converted basis with the common stock.

In connection with the Series D preferred stock issuance, we issued warrants to purchase an additional 1,244,016 shares of our common stock at an exercise price of $2.55 per share. The warrants will not be exercisable until June 3, 2008 and will terminate on the second anniversary of the date upon which they become exercisable.

The holders of Series D preferred stock have the right to require us to redeem all or a portion of the Series D preferred stock shares, payable in common stock, upon the occurrence of certain triggering events, as discussed below, 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 preceding the conversion multiplied by (2) the stated value divided by the conversion price; plus all accrued and unpaid dividends or other payments on such shares. In addition, at any time after the two-year anniversary of the original issue date and subject to the prior rights of the Series A, B and C preferred stock, holders of Series D preferred stock have the right to require us to redeem any of their outstanding Series D preferred stock for cash at the stated value plus any accrued but unpaid dividends or other payments due on the shares being redeemed. Based on these redemption features, which are comparable to the redemption features of our other preferred stock, we have classified these shares as mezzanine equity in accordance with the guidance discussed above in the Series A preferred stock.

The net proceeds from the issuance of the Series D preferred stock of approximately $6.0 million were allocated between the fair value of the warrants and the Series D preferred stock. Using the Black-Scholes option pricing model, we calculated the relative fair value of the warrants to purchase 1,244,016 shares of our common stock to be approximately $1.3 million. This relative fair value has been recorded as a reduction of the mezzanine

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

equity balance for the Series D preferred stock and an addition to common stock. Additionally, we calculated a beneficial conversion feature charge related to the conversion price for the Series D preferred stock to common stock of approximately $1.2 million. As the Series D preferred stock can be converted immediately, the amount of the beneficial conversion feature was immediately accreted and resulted in a deemed dividend. This charge was recorded as a dividend expense included in *preferred stock beneficial conversion feature* in determining the net loss attributable to common shareholders.

During the year ended December 31, 2007, 2,500 shares of Series D preferred stock were converted into 956,936 shares of common stock. As of December 31, 2007, we had approximately $23,000 of Series D preferred stock dividends accrued which were paid in January 2008.

*Triggering Events*

Triggering events that will cause the Series A, B, C and D Preferred Stock to become redeemable are as follows:

We fail 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;

We fail 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;

We provide notice to the holders or public notice that we do not intend to comply with requests for conversion of the convertible preferred stock;

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

We fail to observe or perform a covenant, agreement or warranty contained in, or otherwise commit 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 we receive notice of such failure or breach;

We are 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 our shareholders immediately prior to the transaction own less than 66% of the aggregate voting power of the surviving or acquiring entity;

We enter into voluntary or involuntary bankruptcy proceedings that are not dismissed within 60 days, are adjudicated bankrupt or insolvent, have a custodian appointed for any significant part of our assets, make a general assignment for the benefit of creditors, call a meeting of our creditors with a view to arranging a composition, adjustment or restructuring of our debts, or act or fails to act in such a manner that it expressly indicates our consent to, approval of or acquiescence in any such proceedings;

Our 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.

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**8. Convertible Notes and Long-Term Obligations**

The following table summarizes the changes in the principal balances of our convertible notes during the years ended December 31, 2007 and 2006 (in thousands):

| | 5.75% Convertible Senior Notes | 7.5% Convertible Senior Notes | 6.75% Convertible Senior Notes | 4% Convertible Senior Subordinated Notes | 5.75% Convertible Senior Subordinated Notes | 5.75% Convertible Subordinated Notes |
|---|---|---|---|---|---|---|
| Balance at January 1, 2006 | $ | $ | $ 79,000 | $ 55,150 | $ 66,929 | $ 29,640 |
| Issued | | 66,312 | | | | |
| Converted | | (17,560) | (69,345) | | (4) | |
| Redeemed | | | (2,655) | | | |
| Exchanged | | | | | (39,518) | (1,150) |
| Balance at December 31, 2006 | | 48,752 | 7,000 | 55,150 | 27,407 | 28,490 |
| Issued | 23,250 | | | | | |
| Converted | | (15,294) | | | | |
| Exchanged | | | | | (10,500) | (25,580) |
| Balance at December 31, 2007 | $ 23,250 | $ 33,458 | $ 7,000 | $ 55,150 | $ 16,907 | $ 2,910 |

*5.75% convertible senior notes*

In December 2007, we issued approximately $23.3 million aggregate principal amount of our 5.75% convertible senior notes, or 5.75% senior notes, and approximately 5.5 million shares of our common stock in exchange for $10.5 million of our 5.75% convertible senior subordinated notes and $25.58 million of our 5.75% convertible subordinated notes. The exchange was accounted for as an extinguishment of debt in accordance with the provisions of EITF 96-19, *Debtor s Accounting for a Modification or Exchange of Debt Instruments*, since the terms of the 5.75% senior notes resulted in substantially different cash flows. Accordingly, the 5.75% senior notes are initially recorded at an estimated fair value of $26.7 million, and a debt discount of approximately $3.4 million relating to the difference between the fair value and face value of the 5.75% senior notes is being accreted over the four-year life of the notes as additional interest expense using the effective interest method. We recorded interest expense of $37,000 for the year ended December 31, 2007. The exchange resulted in a loss of approximately $1.0 million including a write-off of $0.1 million of unamortized issuance costs attributed to the extinguished notes. Issuance costs related to this transaction were approximately $0.5 million which are recorded in *other assets* and are being amortized to interest expense using the effective interest method over the four-year life of the notes.

The notes are due December 15, 2011 with interest payable semi-annually in June and December. The notes are convertible, at the option of the holder, into shares of our common stock at any time prior to maturity, redemption or repurchase at an initial conversion rate of 333.333 shares of common stock per $1,000 principal amount of the notes, which is subject to adjustments in certain circumstances. This conversion rate is equivalent to a conversion price of approximately $3.00 per share. On or after December 15, 2009, we have the option to redeem all of the notes for cash at any time at a redemption price equal to par plus accrued and unpaid interest up to but not including the redemption date. Subject to certain conditions, the notes will automatically convert if, at any time after December 15, 2009 and prior to maturity, the closing price per share of our common stock has exceeded 140% of the conversion price then in effect for at least 20 trading days within any 30-consecutive trading day period. Upon a change in control, the holder can require us to repurchase the notes at 100% of their principal amount, plus accrued and unpaid interest and any other amounts due up to, but not including, the

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

repurchase date. In addition, upon any of these occurrences (redemption, automatic conversion, or repurchase) we will pay the holder of the notes a make-whole interest payment equal to $115 per $1,000 principal amount of the notes so converted, less any interest paid on such notes prior to the conversion date.

Additionally, we entered into a registration rights agreement, pursuant to which we have agreed to prepare and file a resale registration statement with respect to the 5.75% senior notes, common stock issuable upon conversion of the 5.75% senior notes and the common stock issued in the exchange transaction as described above, no later than 90 days following the issuance of the notes and the common stock. We have also agreed to use our best efforts to cause such registration statement to be declared effective within 180 days of the issuance of the notes. If we fail to timely file or cause such shelf registration to be declared effective, we are required to pay additional interest at 0.50% per annum per U.S. $1,000 principal amount of the notes that are payable, not exceeding the applicable maximum amount of 4.5% per annum or 12% per annum when combined with the stated interest on the notes, regardless of whether one or multiple registration defaults exist. In accordance with FASB Staff Position, or FSP, EITF 00-19-2, *Accounting for Registration Payment Arrangements*, if the transfer of consideration under a registration payment arrangement is probable and can be reasonably estimated at inception, the contingent liability under the registration payment arrangement shall be included in the allocation of proceeds from the related financing transaction using the measurement guidance in SFAS No.5, *Accounting for Contingencies.* At the time of the closing of the exchange, we concluded that the probability of triggering such liquidated damages was remote.

*7.5% convertible senior notes*

In April 2006, we issued approximately $66.3 million aggregate principal amount of our 7.5% notes, approximately $33.2 million of which was issued in a registered offering for cash with net proceeds of approximately $31.2 million, after deducting expenses and the initial purchaser s discounts and commissions. Approximately $33.2 million was issued in a private exchange for approximately $39.5 million aggregate principal amount of our 5.75% convertible senior subordinated notes and approximately $1.2 million aggregate principal amount of our 5.75% convertible subordinated notes. We recognized a net gain of $8.0 million on the early extinguishment and exchange of these notes which is based on the carrying value of the exchanged notes less the fair value of the new notes, net of issuance costs of $0.4 million and accrued interest of $0.9 million attributable to the exchanged notes. We recorded issuance costs related to the 7.5% notes of approximately $2.0 million which are recorded in *other assets* and are being amortized to interest expense using the effective interest method over the five-year life of the notes.

The notes are due April 30, 2011 with interest payable semi-annually in April and October. The notes are convertible, at the option of the holder, into shares of our common stock at any time prior to maturity, redemption or repurchase at an initial conversion rate of 119.63 shares of common stock per $1,000 principal amount of the notes, which is subject to adjustments in certain circumstances. This conversion rate is equivalent to a conversion price of approximately $8.36 per share. On or after April 30, 2009, we have the option to redeem all of the notes for cash at any time at a redemption price equal to par plus accrued and unpaid interest up to but not including the redemption date. Subject to certain conditions, the notes will automatically convert if, at any time after June 26, 2006 and prior to maturity, the closing price per share of our common stock has exceeded 125% of the conversion price then in effect for at least 20 trading days within any 30-consecutive trading day period. In addition, upon certain non-stock changes in control, the holder can require us to repurchase the notes at 100% of their principal amount, plus accrued and unpaid interest to, but not including, the repurchase date. Upon any automatic conversion of the notes, or if the holder exercises their right to require us to repurchase notes in connection with a non-stock change of control, we will pay the holder of the notes a make-whole interest payment equal to $225 per $1,000 principal amount of the notes so converted, less any interest paid on such notes prior to the conversion date.

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

For the years ended December 31, 2007 and 2006, $15.3 million and $17.6 million of our 7.5% notes were converted into 1.8 million and 2.1 million shares of common stock. In connection with the conversion of $13.6 million of these notes in 2007, we made discretionary interest make-whole payments of approximately $2.3 million which is included in *make-whole interest expense* for the year ended December 31, 2007. In connection with the conversion of $7.4 million of these notes in May 2006, we made a discretionary interest make-whole payment of approximately $1.7 million which is included in *make-whole interest expense* for the year ended December 31, 2006.

*6.75% convertible senior notes*

In November 2005, we completed the issuance of $82 million of 6.75% convertible senior notes due October 31, 2010 with interest payable semi-annually in April and October. Net proceeds to us were approximately $77.7 million, after deducting expenses and the initial purchaser s discounts and commissions. We recorded issuance costs related to the notes of approximately $4.9 million which includes approximately $0.6 million related to the Black-Scholes estimated fair value of warrants issued to the initial purchaser of the notes. These issuance costs are recorded in *other assets* and are being amortized to interest expense using the effective interest method over the five-year life of the notes.

The notes are convertible, at the option of the holder, into shares of our common stock at any time prior to maturity, redemption or repurchase at an initial conversion rate of 95.09 shares of common stock per $1,000 principal amount of the notes, which is subject to adjustment in certain circumstances. This conversion rate is equivalent to a conversion price of approximately $10.52 per share. We also issued warrants to purchase 87,500 shares of common stock within five years at an exercise price of $14.00 per share to the initial purchaser of these notes. We have the option to redeem all of the notes if the closing price per share of our common stock has exceeded 125% of the conversion price then in effect for at least 20 trading days within any 30-consecutive trading day period. The redemption price will be par including accrued and unpaid interest up to but not including the redemption date. Upon any conversion of the notes, we will pay the holder of the notes a make-whole interest payment equal to $337.50 per $1,000 principal amount of the notes so converted, less any interest paid on such notes prior to the conversion date.

On April 30, 2006, holders of the notes had the right to cause us to redeem in cash up to 30% of the aggregate amount of the notes, or approximately $24.6 million, on a pro-rata basis, excluding any accrued and unpaid interest. Certain holders of the notes exercised their right and we redeemed approximately $2.7 million in aggregate principal of these notes. For the years ended December 31, 2006 and 2005, $69.3 million and $3.0 million of the 6.75% notes were converted into 6.6 million and 0.3 million shares of common stock, respectively. This resulted in make-whole interest payments of $23.1 million and $1.0 million for the years ended December 31, 2006 and 2005, respectively. There were no conversions of 6.75% notes for the year ended December 31, 2007.

*Conversion and Placement Agreement*

In November 2005, in conjunction with issuance of the 6.75% convertible senior notes, we entered into a Conversion and Placement Agreement, or CAP agreement, with two existing holders of approximately $18.5 million of our outstanding 5.75% Convertible Senior Subordinated Notes, or 5.75% notes, and approximately $19.9 million of our 4% Convertible Senior Subordinated Notes, or 4% notes. Pursuant to the original terms of the agreement, the CAP holders agreed to exercise their right to convert their 5.75% notes and 4% notes into approximately 0.8 million shares of our common stock. In connection with the conversion, we also issued to the CAP holders a $23.6 million conversion inducement which consisted of 0.8 million shares of common stock and

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

1.6 million shares issuable upon exercise of zero strike price warrants. The shares and warrants were valued based on the trading price of our common stock on the effective date of the agreement. The conversion inducement was recorded as *debt conversion expense* during the year ended December 31, 2005.

Under the terms of this agreement we were required to file a resale registration statement with respect to these shares which was required to be declared effective by November 30, 2005. We filed the resale registration statement on November 30, 2005, however it was not declared effective until December 2005 and as a result, we were required to make a liquidated damages payment of approximately $1.2 million which is included in *interest expense* for the year ended December 31, 2005.

*Convertible senior subordinated notes*

In June 2003, we issued $75.0 million principal amount of 4.0% convertible senior subordinated notes due July 1, 2010 with interest payable semi-annually in January and July. Net proceeds to us were approximately $72.1 million, after deducting expenses and the initial purchaser s discounts and commissions. We recorded issuance costs related to the notes of approximately $2.9 million. These issuance costs are recorded as *other assets* and are being amortized to interest expense using the effective interest method, over the seven-year life of the notes.

The notes are convertible, at the option of the holder, into shares of our common stock at any time prior to maturity, redemption or repurchase at an initial conversion rate of 18.5185 shares of common stock per $1,000 principal amount of notes, which is subject to adjustment in certain circumstances. This conversion rate is equivalent to a conversion price of approximately $54.00 per share. Prior to maturity, we may redeem the notes upon certain conditions, the most significant of which is that the closing price of our common stock must exceed 150% of the conversion price for at least 20 trading days within a period of 30 consecutive trading days. Upon such redemption, we would make an additional payment of $280.00 per $1,000 note, less any interest previously paid on the notes. The holder may elect to convert their notes prior to any such redemption.

In connection with the exchange of convertible subordinated notes in December 2002 as described below, we issued $85.5 million of 5.75% convertible senior subordinated notes and recorded additional issuance costs of approximately $2.1 million, which are recorded in *other assets* and are being amortized to interest expense using the effective interest method, over the remaining life of the notes. The terms of the new notes are similar to the convertible subordinated notes except for the conversion price and provisional redemption provision. The conversion rate for these notes is 25 shares per $1,000 principal note; this is equivalent to a conversion price of $40.00 per share. We can redeem the notes at specified redemption prices ranging from 103.286% to 100% of the principal amount. The redemption prices will vary depending on the year redeemed. The holder may elect to convert their notes prior to any such redemption.

In December 2007, $10.5 million of 5.75% convertible senior subordinated notes were cancelled in exchange for approximately 2.4 million shares of our common stock and $4.8 million of our 5.75% convertible senior notes as described above. We recognized a net loss of $24,000 on the early extinguishment of these notes resulting from the acceleration of the remaining unamortized debt issuance costs.

Additionally, in February 2008, approximately $8.9 million of the 5.75% convertible senior subordinated notes were cancelled in exchange for approximately 6.7 million shares of our common stock.

*Convertible subordinated notes*

In June and September 2001, we issued a total of $175.0 million principal amount of 5.75% convertible subordinated notes due June 15, 2008 with interest payable semi-annually in June and December. Net proceeds to us

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

were approximately $168.0 million, after deducting expenses and the initial purchaser s discounts and commissions. We recorded issuance costs related to the notes of approximately $7.0 million. Issuance costs are recorded in *other assets* and amortized to interest expense over the life of the notes using the effective interest method.

The notes are convertible, at the option of the holder, into shares of our common stock at any time prior to maturity or redemption at a conversion rate of 7.353 shares per each $1,000 principal note, subject to adjustment in certain circumstances. This is equivalent to a conversion price of $136.00 per share. We can redeem the notes at specified redemption prices ranging from 103.286% to 100% of the principal amount. The redemption prices will vary depending on the year redeemed. The holder may elect to convert their notes prior to any such redemption.

In December 2002, we completed an exchange offer for the 5.75% convertible subordinated notes, in which approximately $145.4 million of our convertible subordinated notes were tendered in exchange for approximately $85.5 million of our new convertible senior subordinated notes. We recognized a net gain of $55.3 million on the early extinguishment of these notes. This net gain is based on the carrying value of the exchanged notes less the fair value of the new notes, net of issuance costs of $4.6 million attributable to the exchanged notes. In addition, $1.2 million of these notes were exchanged for our 7.5% notes in April 2006 as described above.

In December 2007, $25.6 million of 5.75% convertible subordinated notes were cancelled in exchange for approximately 3.0 million shares of our common stock and $18.5 million of our 5.75% convertible senior notes as described above. We recognized a net loss of $75,000 on the early extinguishment of these notes resulting from the acceleration of the remaining unamortized debt issuance costs.

Additionally, in February 2008, $150,000 of the 5.75% convertible subordinated notes were cancelled in exchange for approximately 0.1 million shares of our common stock.

*Embedded Features*

The interest make-whole provision of the 7.5% notes represents an embedded derivative which is required to be accounted for separate from the underlying notes. At the issuance of the 7.5% notes, the interest make-whole feature was estimated to have a fair value of approximately $3.7 million and the initial recorded value of the 7.5% notes was reduced by this allocation. In addition, at December 31, 2006, we recorded an increase to the derivative balance of $1.8 million which represents the changes in value as a result of the modification of the terms of the make-whole provision related to certain investors. The resulting discount to the notes is being accreted over the life of the notes as additional interest expense using the effective interest method. Accordingly, we recorded interest expense of $2.9 million and $1.4 million for the years ended December 31, 2007 and 2006, respectively, the majority of which represents accelerated accretion due to note conversions. The estimated fair value of the derivative liability is adjusted quarterly for changes in the estimated market value. The change in the estimated fair value for the years ended December 31, 2007 and 2006 was $3.6 million and $1.9 million, respectively, and is included in *gain on derivative liabilities*. At December 31, 2007, no value was assigned to the fair value of the derivative liability. At December 31, 2006, the fair value of the derivative was $3.6 million, $2.3 of which is recorded in *current portion of derivative liability* and $1.3 million of which is recorded in *7.5% convertible senior notes*.

The interest make-whole provision of the 6.75% notes represents an embedded derivative which is required to be accounted for separate from the underlying notes and was recorded as a derivative liability and a discount to the carrying value of the notes. At the issuance of the 6.75% senior notes, the interest make-whole feature was estimated to have a fair value of approximately $4.5 million and the initial recorded value of the 6.75% senior notes was reduced by this allocation. The resulting discount to the notes is being accreted over the life of the

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

notes as additional interest expense using the effective interest method. Accordingly, we recorded interest expense of approximately $0.1 million, $4.0 million and $0.3 million for the years ended December 31, 2007, 2006 and 2005, respectively. The expense recorded for 2006 and 2005 was primarily related to accelerated accretion due to note conversions. The estimated fair value of the derivative liability is adjusted quarterly for changes in the estimated market value. Changes in the estimated fair value for the years ended December 31, 2007, 2006 and 2005 were $0.1 million, $4.1 million and $0.2 million, respectively, and included in *gain on derivative liabilities.* At December 31, 2007 and 2006, the fair value of the derivative was $0.1 million and $0.2 million and was recorded in *6.75% convertible senior notes.*

The interest make-whole provision of the 5.75% convertible senior notes represents an embedded derivative. At the issuance of the 5.75% notes, no value was assigned to the fair value of the interest make-whole feature.

*Long-term obligations*

Long-term obligations consist of the following as of December 31 (in thousands):

| | 2007 | 2006 |
|---|---|---|
| Capital lease equipment financing agreement, due May 2010, monthly payments of $1, including interest at 6.0% | $ 44 | $ 63 |
| Capital lease equipment financing agreement, due February 2008, monthly payments of $7, including interest at 5.1% | 54 | 125 |
| Excess facilities liability | 1,547 | 3,951 |
| Accrued rent | 1,567 | 1,759 |
| Employee defined benefit plan (see Note 14, *Employee Benefit Plans*) | 1,034 | 923 |
| European public loans | 241 | 529 |
| Other long-term obligations | 6,412 | 133 |
| | 10,899 | 7,483 |
| Less current portion | (1,020) | (2,816) |
| | $ 9,879 | $ 4,667 |

As of December 31, 2007, maturities of the convertible senior, convertible senior subordinated, and convertible subordinated notes as well as other long-term obligations listed above, excluding contingent consideration classified as a non-current liability, our liability for excess facilities and the employee defined benefit plan, are as follows (in thousands):

| **Years Ending December 31,** | |
|---|---|
| 2008 | $ 20,311 |
| 2009 | 408 |
| 2010 | 62,538 |
| 2011 | 57,199 |
| 2012 | 356 |
| Thereafter | |
| | $ 140,812 |

**9. Significant Agreements**

*Collaboration and Licensing Agreements*

*Zevalin acquisition*. On August 15, 2007, we entered into an asset purchase agreement with Biogen for the acquisition of the U.S. rights to develop, market and sell Zevalin, a radiopharmaceutical. We closed this acquisition on December 21, 2007 with an up-front payment of $10 million; however, the terms of the asset

**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

purchase agreement also require us to pay royalties to Biogen for the U.S. rights to Zevalin until the latest of (a) the expiration date of the last to expire of any patents related to Zevalin, (b) the first date on which any third person lawfully sells a biosimilar product in the United States or (c) December 31, 2015. In addition, we are required under that agreement to make up to two additional future payments to Biogen in the amount of $10 million each in the event that we reach certain milestones related to regulatory approval of additional uses of Zevalin.

*Novartis International Pharmaceutical Ltd.* In September 2006, we entered into an exclusive worldwide licensing agreement with Novartis International Pharmaceutical Ltd., or Novartis, for the development and commercialization of paclitaxel poliglumex. Total product registration and sales milestones due from Novartis for paclitaxel poliglumex under the agreement could reach up to $270 million. The agreement also provides Novartis with an option to develop and commercialize pixantrone based on agreed terms. If Novartis exercises its option on pixantrone under certain conditions, Novartis would pay CTI a $7.5 million license fee, up to $104 million in registration and sales related milestones and a royalty on pixantrone worldwide net sales as well as reimbursement for certain expenses. As of December 31, 2007, we have not received any milestone payments.

*Nippon Shinyaku Co., Ltd.* In December 2002, we entered into a distribution agreement with Nippon Shinyaku Co., Ltd., or Nippon, which Cephalon assumed in connection with the TRISENOX divestiture in July 2005. This agreement granted an exclusive license to Nippon to market and distribute TRISENOX in Japan, South Korea and Taiwan. Pursuant to a supply agreement we entered into with Nippon, we recorded $1.3 million in product sales during 2005.

*Chugai Pharmaceutical Co., Ltd.* In October 2001, we entered into a licensing agreement with Chugai for the development and commercialization of paclitaxel poliglumex in several Asian territories. Upon execution of the agreement, Chugai paid us a $3.0 million upfront fee which was recorded as deferred revenue and originally recognized as revenue over the estimated development period of approximately seven years on a straight-line basis. In October 2005, Chugai notified us of their intent to terminate the agreement and accordingly, we recognized the remaining deferred revenue of $1.4 million in the fourth quarter of 2005 as there was no additional planned development period. The agreement was terminated effective March 2006.

*PG-TXL Company, L.P.* In 1998, we entered into an agreement with PG-TXL Company, L.P., as amended in February 2006, granting us an exclusive worldwide license for the rights to polyglutamic acid paclitaxel, a water soluble form of the cancer drug Taxol, and to all potential uses of PG-TXL Company, L.P. s polymer technology. Under the terms of the agreement, we acquired the rights to the research, development, manufacture, marketing and sale of anti-cancer drugs developed using this polymer technology.

We are obligated to make payments to PG-TXL Company upon the achievement of certain development and regulatory milestones. To date we have made $5.6 million in milestone payments and could be obligated to make additional payments of up to $14.9 million in the future if additional milestones are met. We also granted warrants to purchase 87,500 shares of our common stock to PG-TXL Company, L.P. which became exercisable upon our entering a licensing agreement for paclitaxel poliglumex with Chugai Pharmaceutical Co., Ltd (see Note 12, *Capital Stock and Warrants*).

In connection with the agreement with PG-TXL Company, we also entered into Signing Bonus and Restricted Stock and Share Grant Agreements and Consulting Agreements with certain individuals affiliated with PG-TXL Company, L.P., or the PG-TXL Affiliates. The Company also granted 25,916 restricted share rights to the PG-TXL Affiliates, 22,000 of which vested and were issued in February 2006 in connection with the amendment to the License Agreement. For the year ended December 31, 2005, we recorded approximately $0.2

**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

million in research and development expense in anticipation of the vesting of these restricted share rights. The remaining restricted share rights vest upon certain performance conditions which include successfully completing a phase III clinical trial of a licensed product and receiving regulatory approval of an NDA by the FDA. We will begin to record compensation expense at the time the vesting of the share rights become probable.

*Financing Agreement*

On June 21, 2006, we entered into a Step-Up Equity Financing Agreement, as amended on December 15, 2006, with Société Générale. Subject to certain conditions, the agreement allows us to issue to Société Générale shares of our common stock in a series of tranches over a period of 24 months beginning January 31, 2007. Under the agreement, we can initially issue up to 45 million worth of our common stock based on a pre-determined formula and have the right to increase the total amount of all issuances to up to 60 million (approximately $88 million as of December 31, 2007) worth of our common stock. Any issuance of our common stock pursuant to this agreement is at our election and we are not required to issue any common stock. In addition, our ability to issue our common stock under this agreement depends in part on complying with certain Italian regulations.

Upon effectiveness of the agreement we paid a fee of approximately $1.1 million and, including this payment, have incurred total expenses related to this agreement of approximately $1.2 million which are recorded in *other assets* as of December 31, 2007. In addition, we incurred costs of approximately $1.1 million to file a Listing Prospectus in Italy in order to utilize the funding under this agreement. These costs are also recorded in *other assets* as of December 31, 2007. These amounts will be reduced against future equity issuances under the agreement. Upon each settlement of a share issuance, we must pay a subscriber fee equal to 3.5% of the selling price as well as 2.0% of the aggregate selling amount raised during each fiscal quarter. As of December 31, 2007, there had not been any shares of common stock issued under this agreement.

In January 2008, we sold 800,000 shares to Société Générale under this agreement in a registered offering at an issue price of 1.07 per share. Gross proceeds were approximately $1.3 million.

*Security Agreement*

On December 21, 2007, in connection with our acquisition of Zevalin, we entered into a security agreement with Biogen pursuant to which we granted a first priority security interest to Biogen in all of our right, title and interest (a) in and to certain assets that we purchased in connection with the acquisition of Zevalin, together with any other assets or rights related to any of such assets or otherwise used in the development, manufacture or commercialization of Zevalin and (b) under certain license, sublicense and supply agreements entered into pursuant to the acquisition of Zevalin. Upon the occurrence of an ongoing event of default including, without limitation, our failure to pay or perform our obligations under the security agreement, the asset purchase agreement, which includes future royalty and milestone payments due to Biogen, or the related sublicense and service agreements, a breach by us of our representations and warranties under the security agreement, an application by us for, or consent by us to, the appointment of a receiver, trustee or liquidator of all or a substantial portion of our assets, the transfer by us of our assets as part of a general assignment or other arrangement for the benefit of creditors, our insolvency, the filing of a voluntary or involuntary petition filed under the provisions of the Unites States Bankruptcy Code, or the attachment or execution upon, or seizure of, all or substantially all of our assets, Biogen may take any action with respect to the collateral pledged under the security agreement that it deems necessary or advisable to accomplish the purposes of the security agreement. The security agreement creates a continuing security interest in the collateral that will remain in full force and effect until the payment or performance in full of all of the obligations secured by the agreement.

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*Other Significant Agreements*

We have several agreements with clinical research organizations, third party manufacturers, and distributors which have a duration greater than one year for the development of our products.

**10. Divestiture of TRISENOX and Certain Proteasome Assets and Extinguishment of PharmaBio Royalty Obligation**

On July 18, 2005, we divested TRISENOX and certain proteasome assets to Cephalon. In addition, we provided transition services related to TRISENOX and proteasome assets for approximately six months subsequent to the closing date. We received aggregate consideration of $71.9 million for the assets and transition services, net of broker fees. As part of the transaction Cephalon purchased the capital stock of two wholly-owned subsidiaries, Cell Therapeutics (UK) Limited and PolaRx and assumed certain liabilities. There was $2.4 million in assets and $1.7 million in liabilities included in the disposal group related to the divestiture. In addition, we may receive up to an additional $100 million in payments upon achievement by Cephalon of specified sales and development milestones. However, achievement of such milestones is uncertain.

In December 2004, we entered into a financing and services agreement with PharmaBio. In return for cash and services, we were required to pay PharmaBio royalties based on a percentage of net sales of TRISENOX. As a result of the divestiture of TRISENOX, we were required to repay this royalty obligation to PharmaBio. The aggregate termination payment of $39.4 million was made on July 18, 2005 and a $6.4 million loss on the extinguishment of this royalty obligation was recognized for the year December 31, 2005.

Under the agreement, we were entitled to receive $5.0 million in services from PharmaBio and its affiliates (the Prepaid Service Commitment) which may be used through December 31, 2010. As of December 31, 2006, we had $0.6 million remaining under the Prepaid Service Commitment which is included in *prepaid expenses and other current assets.* All remaining prepaid services under the agreement were utilized during 2007.

**11. Restructuring Activities**

During 2005, we reduced our workforce in the U.S. and Europe and terminated our aircraft lease. In conjunction with our workforce reduction, we also vacated a portion of our laboratory and office facilities and recorded excess facilities charges. For the years ended December 31, 2007, 2006 and 2005, restructuring and related asset impairment charges totaled approximately $0.2 million, $0.6 million and $12.8 million, respectively, which is included in *Restructuring charges and related asset impairments* and comprised of the following:

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| Excess facilities charges | $ 201 | $ 667 | $ 7,092 |
| Employee separation cost | | (80) | 3,478 |
| Aircraft lease termination payment | | | 1,170 |
| Asset impairments | | 4 | 1,040 |
| Total restructuring and related asset impairment charges | $ 201 | $ 591 | $ 12,780 |

*Excess Facilities Charges*

Charges for excess facilities relate to our lease obligation for excess laboratory and office space in the U.S. that we vacated as a result of the restructuring plan. Pursuant to SFAS 146, we recorded restructuring charges when we ceased using this space. For the year ended December 31, 2005 total restructuring charges related to

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

this vacated space was approximately $7.1 million. The charge is calculated as the present value of total lease commitments, net of estimated sublease income. The additional charges for excess facilities for the years ended December 31, 2007 and 2006 were due to changes in our estimate of the timing and amount of cash flows related to these excess facilities as well as adjustments due to the passage of time. As of December 31, 2007 we had approximately $1.5 million accrued related to excess facilities charges, of which approximately $0.5 million was included in *current portion of long-term obligations* and approximately $1.0 million of which was included in *long-term obligations, less current portion*. We will periodically evaluate our existing needs, the current and estimated future values of our subleases, and other future commitments to determine whether we should record additional excess facilities charges or adjustments to such charges.

*Employee Separation Costs*

For the year ended December 31, 2005, employee separation costs associated with the layoffs consist primarily of one-time termination benefits, principally severance payments, recognized in accordance with SFAS 146. The adjustment for the year ended December 31, 2006 relates to changes in estimates of amounts due to employees as well as adjustments due to foreign currency fluctuations.

*Restructuring Related Asset Impairments*

Impairment charges recorded pursuant to SFAS 144, *Accounting for the Impairment or Disposal of Long Lived Assets,* or SFAS 144, primarily included laboratory equipment, computers, and furniture and fixtures which were unlikely to be utilized due to our vacated lab and office space as well as employee terminations and accordingly, were written down to estimated fair market value primarily based on quoted market prices obtained from external sources.

The following table summarizes the changes in the liability for restructuring activities during the years ended December 31, 2007 and 2006 (in thousands):

| | Excess Facilities Charges | Employee Separation Costs | Aircraft Lease Termination |
|---|---|---|---|
| Balance at January 1, 2006 | 6,334 | 1,925 | |
| Charges | 667 | (80) | |
| Foreign currency adjustments | | 12 | |
| Payments | (3,050) | (1,830) | |
| Balance at December 31, 2006 | 3,951 | 27 | |
| Charges | 201 | | |
| Foreign currency adjustments | | 1 | |
| Payments | (2,604) | (19) | |
| Balance at December 31, 2007 | $ 1,548 | $ 9 | $ |

**12. Capital Stock and Warrants**

In December 2007, we issued 3,469,999 shares of common stock in a registered offering to institutional investors and received approximately $7.0 million in gross proceeds. We also issued to the purchasing investors warrants to purchase an additional 3,469,999 shares at $2.02 per share. We incurred approximately $0.5 million in expenses related to this offering.

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Also in December 2007, we issued 5,459,574 shares of our common stock to retire $12.8 million aggregate principal of our 5.75% convertible subordinated and senior subordinated notes.

In July 2007, we issued an aggregate of 4,211,856 shares of our common stock in exchange for outstanding SM common stock in a stock for stock merger (See Note 6, *Acquisitions*)

During 2007, we issued 9,232,940 shares of our common stock upon conversion of our Series A, B, C and D convertible preferred stock (See Note 7, *Convertible Preferred Stock*).

During 2007 and 2006, we issued 1,829,616 and 2,100,697 shares upon conversion of $15.3 million and $17.6 million of our 7.5% convertible senior notes, respectively.

In October 2006, in connection with our licensing and co-development agreement entered into with Novartis, we issued an aggregate of 2,167,630 shares of our common stock for gross proceeds of $15 million. We incurred expenses of approximately $0.2 million related to this offering.

In September 2006, we issued 5,780,348 shares of stock under a common stock offering and received $40 million in gross proceeds. We also issued to the purchasing investors warrants to purchase an additional 1,445,088 shares at $6.92 per share. We incurred approximately $2.2 million in expenses related to this offering. In October 2006, we were notified by the Nasdaq Stock Market that this offering did not comply with the shareholder approval requirements set forth in Nasdaq Marketplace Rule 4350(i)(1)(D). In response to this notification, we repurchased 273,500 shares of common stock and warrants to purchase 1,415,088 shares. In November 2006, warrants to purchase 23,750 shares of common stock were exercised and the remaining warrants expired in December 2006.

We issued 6,594,187 and 285,277 shares upon conversion of $69.3 million and $3.0 million of our 6.75% convertible senior notes during 2006 and 2005, respectively.

In connection with the CAP agreement entered into in November 2005 (see Note 8, *Convertible Notes and Long-Term Obligations*), we issued 830,842 shares of common stock upon conversion of a portion of our 5.75% and 4.0% convertible senior subordinated notes based on the conversion terms of the notes as well as an additional 844,483 shares of common stock and zero strike price warrants to purchase 1,625,000 shares of common stock. All of the warrants were exercised during 2006.

*Warrants*

In December 2007, we issued warrants to purchase 3,469,999 shares of common stock in connection with the issuance of 3,469,999 shares of our common stock as discussed above. The warrants are exercisable at an exercise price of $2.02 per share of our common stock at any time on or after June 20, 2008, for a period of three years.

During 2007, we issued warrants to purchase 8,098,661 shares of our common stock in connection with the issuances of our Series A, B, C and D convertible preferred stock (see Note 7, *Convertible Preferred Stock*). Warrants issued in connection with our Series C convertible preferred stock of 2,596,148 will not be exercisable until January 27, 2008. Warrants issued in connection with our Series D convertible preferred stock of 1,244,016 will not be exercisable until June 3, 2008. No warrants issued in connection with our Series A and B convertible preferred stock have been exercised as of December 31, 2007.

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

In connection with our November 2005 6.75% convertible senior notes offering, we issued warrants to purchase 87,500 shares of common stock within five years at an exercise price of $14.00 per share to the initial purchaser of these notes. The estimated fair value of the warrants of approximately $0.6 million was capitalized as a debt issuance cost and is being amortized over the life of the convertible senior notes of five years. No warrants have been exercised as of December 31, 2007.

In connection with the CAP agreement, in November 2005 we issued approximately 1.6 million zero strike price warrants as well as 850,000 shares to two investors of our 6.75% convertible senior notes for an inducement to convert $38.4 million of our outstanding convertible senior subordinated notes. The conversion inducement was recorded as a debt conversion expense. (see Note 8, *Convertible Notes and Long-Term Obligations*). All warrants were exercised during 2006.

In 2002, we entered into an agreement with The Hope Heart Institute for research services. In connection with this agreement, we issued fully-vested warrants to purchase 25,000 shares of common stock at an exercise price of $40.00 per share. No warrants were exercised and they expired in November 2007. Phillip M. Nudelman, Ph.D., is the chairman of our board of directors, and a member of our audit, compensation, and nominating and governance committees, and President, Chief Executive Officer and a member of the board of directors of the Hope Heart Institute (see Note 18, *Related Party Transactions*).

In 1998, we issued contingently exercisable warrants to purchase 87,500 shares of our common stock in connection with a license agreement with PG-TXL Company, L.P. at a per share exercise price of $80.00. The warrants expire in November 2008. In October 2001, we entered into a licensing agreement with Chugai Pharmaceutical Co, Ltd., or Chugai, allowing them to develop paclitaxel poliglumex within certain territories. The signing of this agreement qualified as an exercise event, and the PG-TXL warrants became exercisable at an exercise price of $80.00. No warrants have been exercised as of December 31, 2007.

*Common Stock Reserved*

A summary of common stock reserved for issuance is as follows as of December 31, 2007:

| | |
|---|---|
| Convertible senior notes | 12,418,221 |
| Convertible senior subordinated notes | 1,443,972 |
| Convertible subordinated notes | 21,397 |
| Convertible preferred stock | 6,964,407 |
| Equity incentive plans | 4,755,956 |
| Common stock warrants | 8,273,661 |
| Employee stock purchase plan | 250,000 |
| Restricted share rights | 3,916 |
| | 34,131,530 |

In addition, the 3,469,999 warrants issued in connection with our common stock issuance in December 2007 were not included in the amount reserved for above due to the fact that their exercisability was contingent upon obtaining shareholder approval of an increase in our authorized shares of common stock available for issuance. This approval was obtained in January 2008.

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**13. Stock-Based Compensation**

*Stock-Based Compensation Expense*

On January 1, 2006, we adopted the fair value recognition provisions of SFAS 123(R). Prior to January 1, 2006, we accounted for share-based payments under the recognition and measurement provisions of APB 25, and related interpretations, as permitted by SFAS 123. In accordance with APB 25, no compensation cost was required to be recognized for options granted that had an exercise price equal to the market value of the underlying common stock on the date of grant. Under our plan, stock options are generally granted at fair market value.

We adopted SFAS 123(R) using the modified-prospective transition method. Under this transition method, beginning on the effective date, or January 1, 2006, compensation cost recognized includes (1) compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS 123, and (2) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123(R). In addition, in accordance with the modified-prospective transition method, results for prior periods have not been restated to reflect the impact of SFAS 123(R). We use the straight-line single-option method to recognize the value of stock-based compensation expense for all share-based payment awards granted after January 1, 2006. Expense is recognized using the graded-vesting multiple-option method for options granted prior to January 1, 2006.

Under SFAS 123(R), stock-based compensation expense recognized is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Based on this, our stock-based compensation is reduced for estimated forfeitures at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In our pro forma information required under SFAS 123 for the periods prior to January 1, 2006, we accounted for forfeitures as they occurred.

Stock-based compensation expense recognized under SFAS 123(R) for the year ended December 31, 2007 and 2006 was $1.6 million and $4.1 million, which consisted of $0.9 million and $2.5 million of stock-based compensation expense related to employee stock options and employee stock purchases and $0.7 million and $1.6 million of stock-based compensation expense related to share awards, respectively. Stock-based compensation expense recognized for share awards was $3.3 million during the year ended December 31, 2005. There was no stock-based compensation expense related to employee stock options and employee stock purchases recognized during the year ended December 31, 2005.

The following table summarizes stock-based compensation expense related to employee and director stock options, employee stock purchases, and share awards under SFAS 123(R) for the years ended December 31, 2007 and 2006, which was allocated as follows (in thousands):

| | 2007 | 2006 |
|---|---|---|
| Research and development | $ 772 | $ 2,455 |
| Selling, general and administrative | 811 | 1,671 |
| Stock-based compensation expense included in operating expenses | $ 1,583 | $ 4,126 |

Stock-based compensation had a $1.6 million and $4.1 million effect on our net loss attributable to common shareholders and a $(0.03) and $(0.15) effect on basic and diluted net loss per common share for the years ended December 31, 2007 and 2006, respectively. There was no effect on cash flows from operations or financing activities for the periods presented.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

SFAS 123(R) requires the disclosure of pro-forma information for periods prior to the adoption. The following table illustrates the effect on net loss and net loss per share for the year ended December 31, 2005 if we had recognized compensation expense for all share-based payments to employees based on their fair values (in thousands, except per share amounts):

| | Year Ended December 31, 2005 |
|---|---|
| Net loss, as reported | $ (102,505) |
| Add: Stock-based employee compensation included in reported net loss (share awards) | 3,253 |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards | (5,684) |
| Pro forma net loss | $ (104,936) |
| Basic and diluted net loss per share: | |
| As reported | $ (6.35) |
| Pro forma | $ (6.50) |

Fair value was estimated at the date of grant using the Black-Scholes pricing model, with the following weighted average assumptions:

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2007 | 2006 | 2005 |
| Risk-free interest rates | 3.9% | 4.8% | 4.1% |
| Expected dividend yield | None | None | None |
| Expected life (in years) | 3.0 | 2.8 | 3.5 |
| Volatility | 76% | 74% | 90% |

The risk-free interest rate used in the Black-Scholes valuation method is based on the implied yield currently available in U.S. Treasury securities at maturity with an equivalent term. We have not declared or paid any dividends on our common stock and do not currently expect to do so in the future. The expected term of options represents the period that our stock-based awards are expected to be outstanding and was determined based on historical weighted average holding periods and projected holding periods for the remaining unexercised shares. Consideration was given to the contractual terms of our stock-based awards, vesting schedules and expectations of future employee behavior. Expected volatility is based on the annualized daily historical volatility, including consideration of the implied volatility and market prices of traded options for comparable entities within our industry.

Our stock price volatility and option lives involve management s best estimates, both of which impact the fair value of the option calculated under the Black-Scholes methodology and, ultimately, the expense that will be recognized over the life of the option. SFAS 123(R) also requires that we recognize compensation expense for only the portion of options expected to vest. Therefore, we applied estimated forfeiture rates ranging from 0% to 38% that we derived from historical employee termination behavior. If the actual number of forfeitures differs from our estimates, additional adjustments to compensation expense may be required in future periods.

Stock compensation expense for options granted to non-employees has been determined in accordance with SFAS 123(R) and EITF 96-18 at the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measured. The fair value of options granted to non-employees is periodically remeasured as the underlying options vest.

No tax benefits were attributed to the stock-based compensation expense because a valuation allowance was maintained for substantially all net deferred tax assets.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*Stock Options*

During 2007, shareholders approved our amended and restated 2003 Equity Incentive Plan which was retitled as our 2007 Equity Incentive Plan, or 2007 Plan. In addition, we have our 1994 Equity Incentive Plan, or 1994 Plan, which has been terminated, except with respect to outstanding awards granted prior to termination of the 1994 Plan. The 2007 Plan provides for the grant of the following types of incentive awards: (1) stock options, including incentive stock options and nonqualified stock options, (2) stock appreciation rights, (3) restricted stock, (4) restricted stock units and (5) cash awards. There are 6,610,822 shares authorized under the 2007 Plan including the authorization for issuance of an additional 5,000,000 shares of common stock as set forth in an October 2007 amendment to the 2007 Plan approved by our shareholders at our 2007 Annual Meeting of Shareholders.

In December 2003, the Board of Directors approved the assumption and amendment and restatement of the Cell Therapeutics, Inc. Novuspharma S.p.A. Stock Option Plan, or 2004 Plan, in connection with the merger between CTI and Novuspharma. The Plan provided for the grant of nonqualified stock options and restricted stock to certain of our officers, employees, members of our Board of Directors and consultants. There were 87,500 shares of common stock authorized under the 2004 Plan which was terminated as of December 31, 2006 except with respect to outstanding awards granted prior to such termination.

The Plans are administered by the Compensation Committee of the Board of Directors which has the discretion to determine which employees, consultants and directors shall be granted incentive awards. Options are typically exercisable ratably over a four-year period commencing one year from the date of grant, and expire not more than 10 years from the date of grant. As of December 31, 2007, 2,523,974 shares of common stock were available for future grants.

The following table summarized stock option activity for all of the stock option plans is as follows:

| | Options | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value (Thousands) |
|---|---|---|---|---|
| Outstanding January 1, 2005 (941,669 exercisable) | 1,487,000 | $ 59.67 | | |
| Granted | 737,000 | $ 16.52 | | |
| Exercised | (11,000) | $ 14.24 | | |
| Forfeited | (326,000) | $ 31.14 | | |
| Cancelled and expired | (360,000) | $ 65.76 | | |
| Outstanding December 31, 2005 (904,988 exercisable) | 1,527,000 | $ 43.82 | | |
| Granted | 271,000 | $ 7.01 | | |
| Exercised | | $ | | |
| Forfeited | (120,000) | $ 16.38 | | |
| Cancelled and expired | (139,000) | $ 45.16 | | |
| Outstanding December 31, 2006 (1,177,784 exercisable) | 1,539,000 | $ 39.37 | | |
| Granted | 959,000 | $ 3.92 | | |
| Exercised | | $ | | |
| Forfeited | (72,000) | $ 13.53 | | |
| Cancelled and expired | (194,000) | $ 28.42 | | |
| Outstanding December 31, 2007 | 2,232,000 | $ 25.93 | 7.0 | $ |

| | | | | |
|---|---|---|---|---|
| Vested or expected to vest at December 31, 2007 | 2,022,247 | $ 28.05 | 7.1 | $ |
| Exercisable at December 31, 2007 | 1,271,423 | $ 42.02 | 5.4 | $ |

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The weighted average exercise price of shares exercisable at December 31, 2006 and 2005 was $47.47 and $62.43, respectively. The total intrinsic value of options exercised during the year ended December 31, 2005 was $0.2 million. The weighted average fair value of options granted was $1.93, $3.57 and $10.89 during 2007, 2006, and 2005, respectively.

In May 2001, the Compensation Committee of the Board of Directors approved the rescission of certain stock option exercises that two officers and a consultant had made in January 2001. In exchange for the return of 22,846 shares of our common stock, we reinstated their original option grant and returned to them the related aggregate exercise price of $0.3 million. These options are subject to variable stock compensation accounting until the earlier of the expiration of the option grants or the end of the tax year in which the options are exercised. As of December 31, 2007, 4,792 options are still subject to variable stock compensation accounting.

In accordance with EITF 96-18, all equity instruments issued to non-employees are accounted for at the estimated fair value of the equity instruments. The value of the instrument is amortized to expense over the vesting period with final valuation measured on the vesting date. At December 31, 2007, 2006 and 2005, options to acquire 118,000, 13,750 and 12,592 shares of common stock, respectively, were accounted for based on their estimated fair values. We recorded compensation expense of $4,000 and $19,000 in 2007 and 2006, respectively, and reversed previously recorded stock compensation expense of $49,000 in 2005 related to the issuance of these stock options.

The following table summarizes information about common stock options outstanding at December 31, 2007:

| | Options Outstanding | | | Exercisable Options Outstanding (Without Restriction) | |
|---|---|---|---|---|---|
| Range of Exercise Prices | Number Outstanding | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price | Number Exercisable | Weighted Average Exercise Price |
| $ 1.89 $ 2.57 | 467,700 | 9.64 Years | $ 2.19 | | $ |
| $ 3.56 $ 6.80 | 523,516 | 8.59 Years | $ 5.56 | 129,551 | $ 5.63 |
| $ 6.96 $ 11.60 | 497,091 | 7.55 Years | $ 9.33 | 415,431 | $ 9.69 |
| $11.62 $ 39.52 | 458,361 | 4.01 Years | $ 25.00 | 441,875 | $ 24.58 |
| $40.20 $172.13 | 285,314 | 3.49 Years | $ 132.63 | 284,566 | $ 132.87 |
| $ 1.89 $172.13 | 2,231,982 | 6.99 Years | $ 25.93 | 1,271,423 | $ 42.02 |

*Restricted Stock*

We issued 1,971,254, 31,598 and 573,109 shares of restricted common stock in 2007, 2006 and 2005, respectively. Additionally, 118,163, 33,531 and 163,695 shares of restricted stock were cancelled during 2007, 2006 and 2005, respectively. The weighted average fair value of restricted shares issued during 2007, 2006 and 2005 was $1.86, $7.05 and $19.58, respectively.

Deferred stock-based compensation recorded for the restricted share grants for the years ended December 31, 2005 was approximately $4.4 million, which generally represented the fair value of our stock issued on the date of grant. We reversed deferred stock-based compensation of $2.2 million in 2005, related to cancellations of restricted shares. In 2006 we reversed all remaining deferred stock-based compensation in connection with our implementation of SFAS 123R.

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

We also issued 25,916 restricted share rights to non-employees in 1998 for which ownership vests upon the achievement of clinical trial milestones (see Note 9, *Significant Agreements*). Upon entering into an amendment to the PG-TXL License Agreement in February 2006, we issued 22,000 shares of common stock upon the exercise of these restricted share rights and recorded a research and development expense of approximately $0.2 million for the year ended December 31, 2005.

A summary of the status of nonvested share awards as of December 31, 2007 and changes during the period then ended, is presented below:

| | Nonvested Shares | Weighted Average Grant Date Fair Value Per Share |
|---|---|---|
| Nonvested at December 31, 2006 | 181,682 | $ 24.38 |
| Granted | 1,971,254 | $ 1.86 |
| Vested | (92,825) | $ 7.06 |
| Forfeited | (118,163) | $ 31.20 |
| Nonvested at December 31, 2007 | 1,941,948 | $ 1.93 |

The total fair value of share awards vested during the year ended December 31, 2007, 2006 and 2005 was $0.4 million, $1.5 million and $2.1 million, respectively.

As of December 31, 2007, the total remaining unrecognized compensation cost related to unvested stock options and share awards amounted to $3.1 million, which will be amortized over the weighted-average remaining requisite service period of 1.6 years. This amount does not include unrecognized compensation cost related to 560,000 shares of contingent share awards granted during December 2007.

*Employee Stock Purchase Plan*

During 2007, shareholders approved our 2007 Employee Stock Purchase Plan, or 2007 Purchase Plan, which replaced our 2003 Employee Stock Purchase Plan, or 2003 Purchase Plan, which terminated in April 2006. Under the purchase plans, eligible employees may purchase a limited number of shares of our common stock at 85% of the lower of the subscription date fair market value and the purchase date fair market value. There are two six-month offerings per year. Under the 2003 Purchase Plan, we issued 3,517 and 8,607 shares to employees in 2006 and 2005, respectively. We did not issue any shares under a purchase plan during 2007 as the 2003 Purchase Plan terminated in April 2006 and the 2007 Purchase Plan was not approved until August 2007 which was after the July 1, 2007 start date of the six-month offering period. There are 250,000 shares of common stock authorized under the 2007 Purchase Plan and all are reserved for future purchases as of December 31, 2007.

**14. Employee Benefit Plans**

CTI s U.S. employees participate in the Cell Therapeutics, Inc. 401(k) Plan whereby eligible employees may defer up to 80% of their compensation, up to the annual maximum allowed by the Internal Revenue Service. We may make a discretionary matching contributions based on certain plan provisions. We made contributions of approximately $0.1 million, $0.1 million and $0.2 million during the years ended December 31, 2007, 2006 and 2005, respectively.

In connection with our merger with Novuspharma, on January 1, 2004, we assumed a defined benefit plan and related obligation for benefits owed to our Italian employees who, pursuant to Italian law, are entitled to a

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

lump sum payment upon separation from the Company. Related costs are accrued over the employees service periods based on compensation and years of service. In accordance with EITF 88-1, *Determination of Vested Benefit Obligation for a Defined Benefit Pension Plan*, we have elected to carry the obligation under the plan at the amount of the vested benefit obligation which is defined as the actuarial present value of the vested benefit to which the employee is entitled if the employee separates immediately. Benefits of approximately $0.3 million, $0.8 million and $0.6 million were paid to employees who separated from the Company during 2007, 2006 and 2005, respectively. As of December 31, 2007 and 2006, the vested benefit obligation was approximately $1.0 million and $0.9 million, respectively and was included in *long-term obligations*.

**15. Customer and Geographic Concentrations**

We consider our operations to be a single operating segment focused on the development, acquisition and commercialization of novel treatments for cancer. Financial results of this reportable segment are presented in the accompanying consolidated financial statements.

Product sales were derived from only two customers during 2007 and relate to sales of Zevalin subsequent to its acquisition on December 21, 2007. Product sales during 2005 relate to TRISENOX sales prior to its sale in July 2007. Product sales from each product s major customers as a percentage of total product sales were as follows:

| | Year Ended December 31, | |
|---|---|---|
| | 2007 | 2005 |
| Customer A | 67% | 32% |
| Customer B | 33% | 21% |
| Customer C | N/A | 22% |

All sales of Zevalin during 2007 were to North America. The following table depicts TRISENOX product sales attributed to external customers based on the following geographic locations (in thousands):

| | Year Ended December 31, 2005 |
|---|---|
| North America | $ 11,413 |
| Europe | 1,932 |
| Asia | 2,747 |
| | $ 16,092 |

The following table depicts long-lived assets based on the following geographic locations (in thousands):

| | Year Ended December 31, | |
|---|---|---|
| | 2007 | 2006 |
| United States | $ 39,777 | $ 24,663 |
| Europe | 11,099 | 12,620 |
| | $ 50,876 | $ 37,283 |

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**16. Net Loss Per Share**

Basic and diluted net loss per share is calculated using the weighted average number of shares outstanding as follows (in thousands, except per share amounts):

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2007 | 2006 | 2005 |
| Net loss attributable to common shareholders | $ (148,305) | $ (135,819) | $ (102,505) |
| Basic and diluted: | | | |
| Weighted average shares outstanding | 45,643 | 28,391 | 16,529 |
| Less weighted-average restricted shares outstanding | (351) | (321) | (391) |
| Shares used in calculation of basic and diluted net loss per common share | 45,292 | 28,070 | 16,138 |
| Net loss per common share: | | | |
| Basic and diluted | $ (3.27) | $ (4.84) | $ (6.35) |

As of December 31, 2007, 2006 and 2005, options, warrants, unvested restricted share awards and rights, convertible debt, and convertible preferred stock aggregating 36,769,513, 10,338,278 and 14,206,309 common equivalent shares, respectively, prior to the application of the treasury stock method for options and warrants, were not included in the calculation of diluted net loss per share as their effects on the calculation are anti-dilutive.

**17. Income Taxes**

As of December 31, 2007, we had net operating loss carryforwards of approximately $647 million, of which $57.3 million relates to stock compensation deductions, and research credit carryforwards of approximately $19.2 million. The carryforwards began to expire in 2007.

Due to our equity financing transactions, and other owner shifts as defined in Section 382 of the Internal Revenue Code of 1986, as amended, or the Code, we incurred ownership changes pursuant to the Code. Accordingly, our use of net operating loss carryforwards is limited to approximately $1.5 million annually for losses incurred prior to April 16, 2007 (which aggregate approximately $573.6 million). Due to the nature and use of capital contributions taken into account in calculating the April 16, 2007 annual limitation, we plan to apply to the Internal Revenue Service for a private letter ruling for relief from the provisions of Section 382(l)(1). If successful, we hope to increase the annual limitation to $10.5 million.

Additionally, all losses incurred prior to August 2, 2004 (which aggregate approximately $360 million) are subject to an annual limitation of $12.7 million, and all losses incurred prior to March 27, 1997 (which aggregate $75.5 million) are subject to an annual limitation of approximately $4.2 million. All losses may also be subject to future ownership change limitations. To the extent that any single-year loss is not utilized to the full amount of the limitation, such unused loss is carried over to subsequent years until the earlier of its utilization or the expiration of the relevant carryforward period, which is generally 15-20 years. It is currently expected that approximately $541.8 million of the losses incurred prior to April 16, 2007 will expire unused due to the limitations under Section 382 alone. Additional net operating losses will expire if we do not generate sufficient income to utilize the losses before their normal expiration.

Deferred income taxes reflect the net tax effects of temporary differences between the carrying values of assets and liabilities for financial reporting purposes and income tax reporting. We recognized a valuation

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

allowance equal to net deferred tax assets due to the uncertainty of realizing the benefits of the assets. Our valuation allowance increased $34.6 million, $27.2 million, and $29.6 million during 2007, 2006 and 2005, respectively.

We adopted the provisions of FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes*, or FIN 48, on January 1, 2007 and have analyzed filing positions in our tax returns for all open years. We are subject to U.S. federal and state, and Italian income taxes with varying statutes of limitations. The tax years from 1993 forward remain open to examination due to the carryover of net operating losses or tax credits. Our policy is to recognize interest related to unrecognized tax benefits as interest expense and penalties as operating expenses. As of December 31, 2007, we had no unrecognized tax benefits and therefore no accrued interest or penalties related to unrecognized tax benefits. We believe that our income tax filing positions and deductions will be sustained on audit and do not anticipate any adjustments that will result in a material change to our consolidated financial position, results of operations and cash flows. Therefore, no reserves for uncertain income tax positions have been recorded pursuant to FIN 48. At January 1, 2007, we had no unrecognized tax benefits. In addition, we did not record a cumulative effect adjustment related to the adoption of FIN 48.

Significant components of our deferred tax assets and liabilities as of December 31 are as follows (in thousands):

| | 2007 | 2006 |
|---|---|---|
| Deferred tax assets: | | |
| Net operating loss carryforwards | $ 219,975 | $ 188,378 |
| Capitalized research and development | 72,264 | 68,994 |
| Research and development tax credit carryforwards | 19,235 | 17,963 |
| USAO Settlement | | 3,570 |
| Warrants issued | 3,488 | 3,485 |
| Stock based compensation | 3,282 | 2,865 |
| Depreciation and amortization | 2,392 | 1,623 |
| Lease liability and building impairments | 526 | 1,606 |
| Charitable contributions carryforward | 1,620 | 2,025 |
| Intangible assets | 1,103 | |
| Other deferred tax assets | 1,411 | 1,282 |
| Gross deferred tax assets | 325,296 | 291,791 |
| Less valuation allowance | (324,411) | (289,828) |
| | 885 | 1,963 |
| Deferred tax liabilities: | | |
| GAAP adjustments on Novuspharma merger | (540) | (1,626) |
| Deductions for tax in excess of financial statements | (345) | (337) |
| Gross deferred tax liabilities | (885) | (1,963) |
| Net deferred tax assets | $ | $ |

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The reconciliation between our effective tax rate and the income tax rate as of December 31 is as follows:

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| Federal income tax rate | (34%) | (34%) | (34%) |
| Research and development tax credits | (1) | (1) | (1) |
| Permanent difference IPRD | 5 | | |
| Permanent difference other | 4 | 12 | 1 |
| Valuation allowance | 23 | 20 | 30 |
| Other | 3 | 3 | 4 |
| Net effective tax rate | % | % | % |

**18. Related Party Transactions**

In the case of termination, we have severance agreements with our executive officers that provide benefits for eighteen to twenty-four months.

In May 2007, we formed Aequus Biopharma, Inc., or Aequus, a majority owned subsidiary of which our ownership was approximately 69% as of December 31, 2007. We entered into a license agreement with Aequus whereby Aequus gained rights to our Genetic Polymer technology which Aequus will continue to develop. The Genetic Polymer technology may speed the manufacture, development, and commercialization of follow-on and novel protein-based therapeutics.

In May 2007, we also entered into an agreement to fund Aequus up to $2.0 million in cash in exchange for a convertible promissory note that becomes due and payable in five years and earns interest at a rate of 6% per annum. The note can be converted into equity at any time prior to its maturity upon CTI s demand, or upon other triggering events. The number of shares of Aequus equity securities to be issued upon conversion of this note is equal to the quotient obtained by dividing (i) the outstanding balance of the note by (ii) 100% of the price per share of the equity securities. As of December 31, 2007, we have funded Aequus with an initial payment of $0.5 million. Additional payments of up to $1.5 million will be made upon the achievement of certain milestones. In addition, we have entered into a services agreement to provide certain administrative and research and development services to Aequus. The amounts charged for these services, if unpaid by Aequus within 30 days, will be considered additional principal advanced under the promissory note.

Our President and Chief Executive Officer, James A. Bianco, M.D. and our Executive Vice President, Chief Medical Officer, Jack W. Singer, M.D. are both minority shareholders of Aequus, each owning approximately 4.9% of the equity in the company. Additionally, both Dr. Bianco and Dr. Singer are members of Aequus board of directors and each have entered into a consulting agreement with Aequus. Additionally, Frederick W. Telling, Ph.D., one of our board of directors, owns approximately 1% of Aequus and is also a member of Aequus board of directors.

In November 2002, we entered into a two-year Sponsored Research Agreement with the Hope Heart Institute, a non-profit corporation, which was terminated in 2004. We also granted a fully vested warrant to the Hope Heart Institute to purchase 25,000 shares of our common stock at a purchase price of $40.00 per share which expired in November 2007 (see Note 12, *Capital Stock and Warrants*). Phillip M. Nudelman, Ph.D., is the chairman of our board of directors, and a member of our audit, compensation, and nominating and governance committees, and President, Chief Executive Officer and a member of the board of directors of the Hope Heart Institute. Jack W. Singer, M.D., who is a member of our board of directors and our Executive Vice President, Chief Medical Officer, was a member of the Scientific Advisory Board of the Hope Heart Institute in 2002. We

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

made charitable contributions of $16,500, $6,500 and $24,000 in 2007, 2006 and 2005, respectively. In 2004, we terminated the Sponsored Research Agreement.

In December 2004, we entered into a licensing agreement with DiaKine Therapeutics, Inc., or DiaKine, for the development and commercialization of Lisofylline. We received an upfront payment of $250,000 in 2004 and additional payments of $427,000 in 2005. These payments were recorded as deferred revenue and are being recognized as revenue over the estimated development term in the agreement of December 31, 2013. Jack W. Singer, M.D., is a member of the board of Directors for DiaKine.

**19. Legal Proceedings**

In April 2007, we entered into a settlement agreement with the United States Attorney s Office, or USAO, for the Western District of Washington arising out of their investigation into certain of our prior marketing practices relating to TRISENOX® (arsenic trioxide). Pursuant to this settlement agreement, we made a single payment of $10.6 million to the USAO, which included a settlement amount of $10.5 million and interest accrued on that amount since the date of reaching an agreement in principle, in return for a release of all government claims in connection with a qui tam action brought by a private plaintiff and related matters. This settlement does not address separate claims brought against the Company by the private party plaintiff in such matters, which generally relate to attorneys fees and employment related claims. The private party plaintiff s wrongful termination claims have been dismissed by the federal district court with prejudice. As of December 31, 2006, $10.5 million related to the USAO litigation matter was included in *accrued expenses*. As of March 31, 2007, this amount was increased by approximately $0.1 million to $10.6 million. We made the settlement payment of $10.6 million in April 2007.

On January 22, 2007, we filed a complaint in King County Washington Superior Court against The Lash Group, Inc. and Documedics Acquisition Co., Inc., our former third party reimbursement expert, seeking recovery of damages, including losses incurred by the Company in connection with our above referenced USAO investigation, defense and settlement of claims by the government concerning Medicare reimbursement for TRISENOX. On February 28, 2007, defendant The Lash Group, Inc. removed the case to federal court in the Western District of Washington.

On January 2, 2008, Tang Capital Partners LP, or Tang, filed a civil action in the United States District Court for the Southern District of New York in which Tang alleged that the Company breached a Securities Purchase Agreement that was executed by CTI on or about April 16, 2007 in connection with the issuance of Series B Preferred Stock. Tang alleges that the Company s filing of Articles of Correction to the Articles of Amendment to the Amended and Restated Articles of Incorporation on or around December 11, 2007, materially and adversely altered the powers, preferences or rights conferred through its Securities Purchase Agreement, thereby constituting a Triggering Event, and as a result, Tang is entitled to redemption of its Preferred Stock in consideration for 130% of its Stated Value, plus other available relief, if any. One other holder of Preferred Stock, Enable Capital Management LLC, asserted similar claims in correspondence with the Company in December 2007 and in January 2008 subsequently filed a lawsuit with similar claims to the Tang action. At this time, we are not able to make a determination whether the likelihood of an unfavorable outcome is probable or remote.

In addition to the litigation discussed above, we are from time to time subject to legal proceedings and claims arising in the ordinary course of business, some of which may be covered in whole or in part by insurance.

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**CELL THERAPEUTICS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**20. Subsequent Events**

On January 30, 2008, we announced a plan to refocus our resources on late-stage and marketed products, with the intention of reducing operating expenses throughout the Company. As part of our refocusing efforts, 31 of our U.S. employees were terminated. Estimated costs of up to $550,000 will be recorded for severance-related expenses resulting from this reduction in work force and are expected to be paid within two and a half months of the plan s announcement. Such costs are associated with the severance benefits to be provided to each terminated employee.

On March 3, 2008 we issued approximately $51.7 million of our 9% convertible senior notes due 2012 plus warrants to purchase 7,326,950 shares of our common stock at an exercise price of $1.41 per share. The notes will bear interest at an annual rate of 9% and be convertible into our common stock at an initial rate of approximately 709.22 shares per $1,000 principal amount of the notes, which is equivalent to an initial conversion price of approximately $1.41. Upon conversion of the note, we will be required to pay a make-whole amount to the holders of the converted notes equal to $270 per $1,000 principal amount of the converted notes less any interest paid on such notes prior to the conversion date, or make-whole payment. An amount adequate to pay the make-whole payments on all outstanding notes will be held in escrow for a period of one year. As of March 19, 2008, $28.8 million of these notes had been converted.

In connection with this debt issuance, certain existing holders of our series A, B, C, and D convertible preferred stock converted their shares of preferred stock into common stock. These conversions included 6,300, 10,162, 2,000 and 3,000 shares of series A, B, C and D convertible preferred stock, respectively. To induce these conversions, we paid an aggregate cash payment of approximately $16.2 million.

**21. Unaudited Quarterly Data**

The following table presents summarized unaudited quarterly financial data (in thousands, except per share data):

| | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
|---|---|---|---|---|
| **2007** | | | | |
| Revenues | $ 20 | $ 20 | $ 20 | $ 67 |
| Gross profit | 20 | 20 | 20 | 18 |
| Operating expenses | (23,623) | (24,318) | (49,002) | (36,170) |
| Net loss | (26,114) | (25,962) | (48,471) | (37,561) |
| Net loss applicable to common shareholders | (28,739) | (27,901) | (52,603) | (39,062) |
| Net loss per common share basic and diluted | (0.76) | (0.65) | (1.09) | (0.74) |
| **2006** | | | | |
| Revenues | $ 20 | $ 20 | $ 20 | $ 20 |
| Gross profit | 20 | 20 | 20 | 20 |
| Operating expenses | (26,516) | (23,562) | (23,700) | (24,902) |
| Net loss | (51,916) | (20,472) | (27,832) | (35,599) |
| Net loss per share basic and diluted | (2.32) | (0.80) | (1.00) | (1.00) |

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**Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure**

No disclosure required pursuant to Item 304 of Regulation S-K.

**Item 9A. Controls and Procedures**

(a) Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in reports filed under the Securities Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission, or SEC, rules and forms, and that such information is accumulated and communicated to our management to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, our management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives.

Our management, under the supervision and with the participation of the Company s Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, as of the end of the period covered by this report. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective.

(b) Management s Report on Internal Controls

Management of Cell Therapeutics, Inc., together with its consolidated subsidiaries (the Company), is responsible for establishing and maintaining adequate internal control over financial reporting. The Company s internal control over financial reporting is a process designed under the supervision of the Company s principal executive and principal financial officers to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Company s financial statements for external reporting purposes in accordance with U.S. generally accepted accounting principles.

As of the end of the Company s 2007 fiscal year, management conducted an assessment of the effectiveness of the Company s internal control over financial reporting based on the framework established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, management has determined that the Company s internal control over financial reporting as of December 31, 2007 was effective.

The registered independent public accounting firm of Stonefield Josephson, Inc., as auditors of the Company s consolidated financial statements, has audited our internal controls over financial reporting as of December 31, 2007, as stated in their report, which appears herein.

(c) Changes in Internal Controls

During the period ended December 31, 2006, we identified material weaknesses that affected our internal controls over financial reporting. A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company s annual or interim financial statements will not be prevented or detected on a timely basis.

During 2007, to remedy the material weaknesses in our internal control over financial reporting described in our Annual Report on Form 10-K for the period ended December 31, 2006, we implemented enhanced review and approval procedures that are designed to help ensure we accurately record accounts payable and accrued expense balances in CTI (Europe), and trained personnel in key finance positions in CTI (Europe) regarding the enhanced procedures and appropriate levels of oversight and review. These revised control processes have been

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operating for a sufficient period of time and have been tested to provide management with reasonable assurance as to their effectiveness. Although management believes the material weaknesses have been remediated, we will continue to monitor the effectiveness of the revised procedures.

Due to the timing of our acquisitions of Systems Medicine, Inc. and our commercial product, Zevalin, both were excluded from the scope of our assessment of internal controls over financial reporting for the period ended December 31, 2007. However, during 2008 we anticipate implementing additional controls related to these recent acquisitions. These changes could include implementing transactional controls at the subsidiary level, revenue recognition and cash receipts controls related to product sales in addition to implementing a more sophisticated accounting system.

Except as described above, there have been no changes to our internal control over financial reporting that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Item 9B. Other Information**

None.

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## PART III

### Item 10. Directors, Executive Officers and Corporate Governance

#### Directors

The information pertaining to directors required by Part III, Item 10, will be incorporated herein by reference from the registrant s definitive proxy statement relating to the 2008 annual meeting of shareholders, which definitive proxy statement or amendment to this annual report shall be filed with the Securities and Exchange Commission within 120 days after the end of the fiscal year to which this Report relates.

#### Executive Officers

The following table sets forth certain information with respect to our executive officers:

| Name | Age as of 12/31/07 | Position |
|---|---|---|
| James A. Bianco, M.D. | 51 | President, Chief Executive Officer |
| Louis A. Bianco | 55 | Executive Vice President, Finance and Administration |
| Dan Eramian | 59 | Executive Vice President, Corporate Communications |
| Jack W. Singer, M.D. | 65 | Executive Vice President, Chief Medical Officer |
| Scott C. Stromatt, M.D. | 50 | Executive Vice President, Clinical Development and Regulatory Affairs |

***Dr. Bianco*** is our principal founder and has been our president and chief executive officer since February 1992 and one of our directors since our inception in September 1991. Prior to joining us, Dr. Bianco was an assistant professor of medicine at the University of Washington, Seattle, and an assistant member in the clinical research division of the Fred Hutchinson Cancer Research Center, the world s largest bone marrow transplant center. From 1990 to 1992, Dr. Bianco was the director of the Bone Marrow Transplant Program at the Veterans Administration Medical Center in Seattle. Dr. Bianco received his B.S. Degree in biology and physics from New York University and his M.D. from Mount Sinai School of Medicine. Dr. Bianco is the brother of Louis A. Bianco, our executive vice president, finance and administration.

***Mr. Bianco*** is one of our founders and has been our executive vice president, finance and administration since February 1, 1992, and was a director from our inception in September 1991 to April 1992 and from April 1993 to April 1995. From January 1989 through January 1992, Mr. Bianco was a vice president at Deutsche Bank Capital Corporation in charge of risk management. Mr. Bianco is a Certified Public Accountant and received his M.B.A. from New York University. Mr. Bianco and Dr. Bianco are brothers.

***Mr. Eramian*** was hired as executive vice president, corporate communications in March 2006. Prior to joining us, Mr. Eramian was Vice President of Communications at BIO, an industry organization representing more than 1,200 biotechnology companies, academic institutions, state biotechnology centers and related organizations. Prior to that, he was Assistant Administrator of Communications at the Small Business Administration and Director of Public Affairs at the Department of Justice and Chief Spokesman for the Attorney General.

***Dr. Singer*** is one of our founders and directors and currently serves as our executive vice president, chief medical officer. Dr. Singer has been one of our directors since our inception in September 1991. From July 1995 to January 2004, Dr. Singer was our executive vice president, research program chairman and from April 1992 to July 1995, he served as our executive vice president, research and development. Prior to joining us, Dr. Singer was a professor of medicine at the University of Washington and a full member of the Fred Hutchinson Cancer Research Center. From 1975 to 1992, Dr. Singer was the chief of medical oncology at the Veterans Administration Medical Center in Seattle. Dr. Singer received his M.D. from State University of New York, Downstate Medical College.

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***Dr. Stromatt*** was promoted to executive vice president, clinical development and regulatory affairs in August 2005, and has managed CTI s global clinical research programs and related functional areas since 2003. Prior to joining us, Dr. Stromatt was vice president clinical research and chief medical officer for Northwest Biotherapeutics and, prior to that, was an analyst focused on public and private biotechnology, pharmaceutical, and medical device companies. Dr. Stromatt earned his MD from the University of Chicago and received his MBA from the University of Colorado.

**Compliance with Section 16(a) of the Exchange Act**

The information pertaining to compliance with Section 16(a) of the Exchange Act required by Part III, Item 10, will be incorporated herein by reference from the registrant s definitive proxy statement relating to the 2007 annual meeting of shareholders, which definitive proxy statement or amendment to this annual report shall be filed with the Securities and Exchange Commission within 120 days after the end of the fiscal year to which this Report relates.

**Code of Ethics**

The Company has adopted a code of ethics for its senior executive and financial officers (including its principal executive officer and principal financial officer), as well as a code of ethics applicable to all employees and directors. Both codes of ethics are available on the Company s website at http://www.cticseattle.com/investors_management.htm. Shareholders may request a free copy of the codes of ethics from:

Cell Therapeutics, Inc.

Attention: Investor Relations

501 Elliott Avenue West, Suite 400

Seattle, WA 98119

(206) 282-7100

Any waivers of or amendments to the Company s code of ethics will be posted on its website, at http://www.cticseattle.com.

**Corporate Governance Guidelines**

The Company has adopted Corporate Governance Guidelines, which are available on the Company s website at http://www.cticseattle.com/investors_management.htm. Shareholders may request a free copy of the Corporate Governance Guidelines at the address and phone numbers set forth above.

**Audit Committee Financial Expert**

The Company s board of directors has determined that Audit Committee member John Bauer is an audit committee financial expert as defined by Item 401(h) of Regulations S-K of the Securities Exchange Act of 1934, as amended, or Exchange Act, and is independent within the meaning if Item 7(d)(3)(iv) of Schedule 14A of the Exchange Act.

**Audit Committee**

The Company has an Audit Committee established in accordance with Section 3(a)(58)(A) of the Exchange Act. John Bauer, Vartan Gregorian, Phillip Nudelman and Frederick Telling are the members of the Company s Audit Committee.

**Other Information**

The information required by Part III, Item 10, to the extent not set forth herein, will be incorporated herein by reference from the registrant s definitive proxy statement relating to the 2008 annual meeting of shareholders, which definitive proxy statement or amendment to this annual report shall be filed with the Securities and Exchange Commission within 120 days after the end of the fiscal year to which this Report relates.

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**Item 11. Executive Compensation**

The information required by Part III, Item 11, will be incorporated herein by reference from the registrant s definitive proxy statement relating to the 2008 annual meeting of shareholders, which definitive proxy statement or amendment to this annual report shall be filed with the Securities and Exchange Commission within 120 days after the end of the fiscal year to which this Report relates.

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Shareholder Matters**

The information required by Part III, Item 12, will be incorporated herein by reference from the registrant s definitive proxy statement relating to the 2008 annual meeting of shareholders, which definitive proxy statement or amendment to this annual report shall be filed with the Securities and Exchange Commission within 120 days after the end of the fiscal year to which this Report relates.

**Item 13. Certain Relationships and Related Transactions, and Director Independence**

The information required by Part III, Item 13, will be incorporated herein by reference from the registrant s definitive proxy statement relating to the 2008 annual meeting of shareholders, which definitive proxy statement or amendment to this annual report shall be filed with the Securities and Exchange Commission within 120 days after the end of the fiscal year to which this Report relates.

**Item 14. Principal Accounting Fees and Services**

The information required by Part III, Item 14, will be incorporated herein by reference from the registrant s definitive proxy statement relating to the 2008 annual meeting of shareholders, which definitive proxy statement or amendment to this annual report shall be filed with the Securities and Exchange Commission within 120 days after the end of the fiscal year to which this Report relates.

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**PART IV**

**Item 15. Exhibits, Financial Statement Schedules**

(a) Financial Statements and Financial Statement Schedules

(i) Financial Statements

Management s Report on Internal Control over Financial Reporting

Reports of Stonefield Josephson, Inc, Independent Registered Public Accounting Firm

Report of Grant Thornton LLP, Independent Registered Public Accounting Firm

Consolidated Balance Sheets

Consolidated Statements of Operations

Consolidated Statements of Shareholders Deficit

Consolidated Statements of Cash Flows

Notes to Consolidated Financial Statements

(ii) Financial Statement Schedules

II Valuation and Qualifying Accounts

All other schedules have been omitted since they are either not required, are not applicable, or the required information is shown in the financial statements or related notes.

(iii) Exhibits

| Exhibit Number | Description |
|---|---|
| 2.1(9) | Agreement and Plan of Merger by and between Cell Therapeutics, Inc. and Novuspharma, S.p.A., dated as of June 16, 2003. |
| 3.1(37) | Registrant s Amended and Restated Articles of Incorporation. |
| 3.2(10) | Registrant s Amended and Restated Bylaws. |
| 4.1(3) | Indenture between the Registrant and State Street Bank and Trust Company of California, N.A., as trustee dated June 13, 2001. |
| 4.2(8) | Indenture between the Registrant and State Street Bank and Trust Company of California, N.A., as trustee dated December 20, 2002. |
| 4.3(11) | Indenture between the Registrant and U.S. Bank National Association as trustee, dated June 23, 2003. |

| | |
|---|---|
| 4.4(16) | Indenture between the Registrant and U.S. Bank National Association as trustee, dated November 4, 2005. |
| 4.5(19) | Indenture between Cell Therapeutics, Inc. and U.S. Bank National Association as Trustee, dated April 27, 2006. |
| 4.6(34) | Indenture between Cell Therapeutics, Inc. and U.S. Bank National Association as Trustee, dated December 12, 2007. |
| 4.7(38) | Indenture between Cell Therapeutics, Inc. and U.S. Bank National Association as Trustee, dated March 3, 2008. |
| 4.8(19) | Registration Rights Agreement between Cell Therapeutics, Inc. and the Existing Holders dated April 27, 2006. |
| 4.10(34) | Form of Registration Rights Agreement between Cell Therapeutics and Certain Holders dated December 12, 2007. |

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| Exhibit Number | Description |
|---|---|
| 4.11(25) | Form of Series A 3% Convertible Preferred Stock Certificate. |
| 4.12(27) | Form of Series B 3% Convertible Preferred Stock Certificate. |
| 4.13(30) | Form of Series C 3% Convertible Preferred Stock Certificate. |
| 4.14(33) | Form of Series D 7% Convertible Preferred Stock Certificate. |
| 4.15(25) | Form of Warrant issued February 12, 2007 and February 14, 2007. |
| 4.16(27) | Form of Warrant issued April 16, 2007. |
| 4.17(30) | Form of Warrant issued July 27, 2007. |
| 4.18(33) | Form of Warrant issued December 3, 2007. |
| 4.19(35) | Form of Warrant issued December 21, 2007. |
| 4.20(38) | Form of Warrant issued March 4, 2008. |
| 10.1(6) | Sublease Agreement between F5 Networks, Inc. and the Registrant, dated March 30, 2001, as amended April 13, 2001. |
| 10.2(26) | Third Amendment to Sublease Agreement between F5 Networks, Inc. and the Registrant, dated December 22, 2005. |
| 10.3(8) | Lease agreement between Elliott Park LLC and the Registrant, dated August 20, 2002. |
| 10.4(13)* | Employment Agreement between the Registrant and James A. Bianco, dated as of January 1, 2005. |
| 10.5(14)* | Form of Strategic Management Team Severance Agreement. |
| 10.6(5)* | Form of Indemnification Agreement. |
| 10.7(7)* | 1994 Equity Incentive Plan, as amended. |
| 10.8(32)* | 2007 Employee Stock Purchase Plan, as amended. |
| 10.9(32)* | 2007 Equity Incentive Plan. |
| 10.10(12)* | Cell Therapeutics, Inc. Novuspharma S.p.A. Stock Option Plan |
| 10.11(18)* | Form of Notice of Grant of Award and Award Agreement for grants of restricted stock under the Registrant s 2007 Equity Incentive Plan, as amended. |
| 10.12(18)* | Form of Notice of Grant of Stock Options and Option Agreement for option grants under the Registrant s 2007 Equity Incentive Plan, as amended. |
| 10.13(1)* | Form of Nonqualified Stock Option Agreement for option grants under the Registrant s Novuspharma S.p.A. Stock Option Plan. |
| 10.14(2) | License Agreement dated as of November 13, 1998, by and between PG-TXL Company, L.P. and the Registrant. |
| 10.15(17) | Amendment No. 1 to the License Agreement, dated as of February 1, 2006, by and between the Registrant and PG-TXL Company, L.P. |
| 10.16(4) | Paclitaxel Purchase Agreement dated as of September 28, 2001, between Natural Pharmaceuticals, Inc. and the Registrant. |
| 10.17(15) | Acquisition Agreement by and among the Registrant, Cell Technologies, Inc. and Cephalon, Inc., dated June 10, 2005. |

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| Exhibit Number | Description |
|---|---|
| 10.18(19) | Purchase Agreement between Cell Therapeutics, Inc. and CRT Capital Group LLC, dated April 24, 2006. |
| 10.19(19) | Exchange Agreement by and among Cell Therapeutics, Inc. and the Existing Holders, dated April 24, 2006. |
| 10.20(20) | Step-Up Equity Financing Agreement between Cell Therapeutics, Inc. and Société Générale, dated June 21, 2006. |
| 10.21(21) | Amendment No.1 to the Step-Up Equity Financing Agreement between Cell Therapeutics, Inc. and Société Générale , dated July 31, 2006. |
| 10.22(23) | Amendment No. 2 to the Step-Up Equity Financing Agreement between Cell Therapeutics, Inc. and Société Générale , dated September 30, 2006. |
| 10.23(24) | Amendment No. 3 to the Step-Up Equity Financing Agreement between Cell Therapeutics, Inc. and Société Générale , dated December 15, 2006. |
| 10.24(22) | License and Co-Development Agreement by and among Cell Therapeutics, Inc., Cell Therapeutics Europe S.r.L. and Novartis International Pharmaceutical Ltd. dated September 15, 2006. |
| 10.25(28) | Director Compensation Policy. |
| 10.26(26) | Agreement to Bonus Payment and Contingent Bonus Payment for Officer of the Corporation**.** |
| 10.27(29) | Acquisition Agreement among Cell Therapeutics, Inc., Cactus Acquisition Corp., Saguaro Acquisition Company LLC, Systems Medicine, Inc. and Tom Hornaday and Lon Smith dated July 24, 2007. |
| 10.28(31) | Asset Purchase Agreement between Cell Therapeutics, Inc. and Biogen Idec Inc. dated August 15, 2007. |
| 10.29(36) | Security Agreement between Cell Therapeutics, Inc. and Biogen Idec Inc. dated December 21, 2007. |
| 10.30(36) | Supply Agreement between Cell Therapeutics, Inc. and Biogen Idec Inc. dated December 21, 2007. |
| 10.31(39) | Isotope Agreement between Biogen Idec Inc. and MDS Nordion Inc., as amended by a first amendment on January 21, 2008 and a second amendment on March 16, 2001. |
| 10.32(40) | Third Amendment to Agreement between Biogen Idec Inc. and MDS (Canada) Inc., MDS Nordion division, successor to MDS Nordion Inc. dated November 12, 2001. |
| 10.33(41) | Fourth Amendment to Agreement between Biogen Idec Inc., MDS (Canada) Inc., MDS Nordion division, successor to MDS Nordion Inc., dated June 10, 2003. |
| 10.34(41) | Fifth Amendment to Agreement between Biogen Idec Inc., MDS (Canada) Inc., MDS Nordion division, successor to MDS Nordion Inc., dated June 10, 2003. |
| 12.1 | Statement Re: Computation of Ratio of Earnings to Fixed Charges. |
| 21.1 | Subsidiaries of the Registrant. |
| 23.1 | Consent of Stonefield Josephson, Inc., Independent Registered Public Accounting Firm |
| 24.1 | Power of Attorney. Contained in the signature page of this Annual Report on Form 10-K and incorporated herein by reference. |