

ACACIA RESEARCH CORP  
Form 10-Q  
November 09, 2006

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

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**FORM 10-Q**

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

**FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2006**

**Commission File Number 0-26068**

**ACACIA RESEARCH CORPORATION**  
(Exact Name of Registrant as Specified in Its Charter)

**Delaware**  
(State or Other Jurisdiction of  
Incorporation or Organization)

**95-4405754**  
(I.R.S. Employer  
Identification No.)

**500 Newport Center Drive, Newport  
Beach, CA**  
(Address of Principal Executive Offices)

**92660**  
(Zip Code)

Registrant's telephone number, including area code: **(949) 480-8300**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to filing requirements for the past 90 days. Yes  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

As of October 31, 2006, 28,020,042 shares of Acacia Research-Acacia Technologies common stock were issued and

outstanding. As of October 31, 2006, 41,507,579 shares of Acacia Research-CombiMatrix common stock were issued and outstanding.

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**ACACIA RESEARCH CORPORATION**  
**Table of Contents**

**Part I. Financial Information**

Item 1. Financial Statements

Acacia Research Corporation Consolidated Financial Statements

Consolidated Balance Sheets as of September 30, 2006, and  
December 31, 2005 (Unaudited) 1

Consolidated Statements of Operations and Comprehensive Income (Loss) for the  
Three Months and Nine Months Ended September 30, 2006 and 2005 (Unaudited) 2

Consolidated Statements of Cash Flows for the Nine Months Ended  
September 30, 2006 and 2005 (Unaudited) 3

Notes to Consolidated Financial Statements (Unaudited). 4

\*Acacia Technologies Group Financial Statements

Balance Sheets as of September 30, 2006, and December 31, 2005 (Unaudited) 25

Statements of Operations for the Three Months and Nine Months Ended  
September 30, 2006 and 2005 (Unaudited) 26

Statements of Cash Flows for the Nine Months Ended  
September 30, 2006 and 2005 (Unaudited) 27

Notes to Financial Statements (Unaudited) 28

\*CombiMatrix Group Financial Statements

Balance Sheets as of September 30, 2006, and December 31, 2005 (Unaudited) 33

Statements of Operations for the Three Months and Nine Months Ended  
September 30, 2006 and 2005 (Unaudited) 34

Statements of Cash Flows for the Nine Months Ended  
September 30, 2006 and 2005 (Unaudited) 35

Notes to Financial Statements (Unaudited) 36

Item 2. Management's Discussion and Analysis of Financial Condition and  
Results of Operations 41

Item 3. Quantitative and Qualitative Disclosures About Market Risk	65
Item 4. Controls and Procedures	65

---

**Part II. Other Information**

Item 1. Legal Proceedings	66
Item 1A. Risk Factors	66
Item 6. Exhibits	68
<b>Signatures</b>	<b>69</b>
<b>Exhibit Index</b>	<b>70</b>

\*NOTE: We are presenting the Acacia Research Corporation consolidated unaudited interim financial statements and the separate unaudited interim financial statements for the CombiMatrix group and the Acacia Technologies group. The separate financial statements and accompanying notes of the two groups are being provided as additional disclosure regarding the financial performance of the two divisions and to provide investors with information regarding the potential value and operating results of the respective businesses, which may affect the respective share values. The separate financial statements should be reviewed in conjunction with Acacia Research Corporation's consolidated financial statements and accompanying notes. The presentation of separate financial statements is not intended to indicate that we have changed the title to any of our assets or changed the responsibility for any of our liabilities, nor is it intended to indicate that the rights of our creditors have been changed. Acacia Research Corporation, and not the individual groups, is the issuer of the securities. Holders of the two securities are stockholders of Acacia Research Corporation and do not have a separate and exclusive interest in the respective groups.

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**ACACIA RESEARCH CORPORATION**  
**CONSOLIDATED BALANCE SHEETS**  
(In thousands, except share and per share information)  
(Unaudited)

<b>ASSETS</b>	<b>September 30, 2006</b>	<b>December 31, 2005</b>
<b>Current assets:</b>		
Cash and cash equivalents	\$ 27,791	\$ 20,164
Short-term investments	26,511	39,009
Accounts receivable	2,762	5,332
Prepaid expenses, inventory, and other assets	1,955	2,115
Total current assets	59,019	66,620
Property and equipment, net of accumulated depreciation	2,259	2,484
Patents, net of accumulated amortization	26,931	31,712
Goodwill	17,039	18,980
Other assets	2,747	1,638
	\$ 107,995	\$ 121,434
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Current liabilities:</b>		
Accounts payable and accrued expenses	\$ 5,883	\$ 3,924
Royalties and legal fees payable	2,343	3,758
Current portion of deferred revenues	930	804
Total current liabilities	9,156	8,486
Deferred income taxes	-	2,701
Deferred revenues, net of current portion	1,145	1,439
Other liabilities	736	1,464
Total liabilities	11,037	14,090
Commitments and contingencies (Note 10)		
Minority interests	-	447
<b>Redeemable stockholders' equity:</b>		
<b>Preferred stock</b>		
Acacia Research Corporation, par value \$0.001 per share; 10,000,000 shares authorized; no shares issued or outstanding	-	-
<b>Common stock</b>		
Acacia Research - Acacia Technologies stock, par value \$0.001 per share; 50,000,000 shares authorized; 28,017,459 and 27,722,242 shares issued and outstanding as of September 30, 2006 and December 31, 2005, respectively	28	28
Acacia Research - CombiMatrix stock, par value \$0.001 per share; 50,000,000 shares authorized; 41,405,798 and 38,992,402 shares issued and outstanding as of September 30, 2006 and December 31, 2005, respectively	41	39

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Additional paid-in capital	321,604	315,146
Deferred stock compensation	-	(1,400)
Accumulated comprehensive income	16	(2)
Accumulated deficit	(224,731)	(206,914)
Total stockholders' equity	96,958	106,897
	\$ 107,995	\$ 121,434

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

1

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**ACACIA RESEARCH CORPORATION**  
**CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)**  
(In thousands, except share and per share information)  
(Unaudited)

	For the Three Months Ended		For the Nine Months Ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
<b>Revenues:</b>				
License fees	\$ 8,424	\$ 6,783	\$ 27,512	\$ 11,328
Government contract	725	973	1,563	2,985
Products	968	453	3,050	1,298
Service contracts	151	37	268	106
<b>Total revenues</b>	<b>10,268</b>	<b>8,246</b>	<b>32,393</b>	<b>15,717</b>
<b>Operating expenses:</b>				
Cost of government contract revenues	684	920	1,476	2,820
Cost of product sales	412	282	973	635
Research and development expenses (including non-cash stock compensation expense of \$311 and \$797 for the three and nine months ended September 30, 2006 and \$0 for the three and nine months ended September 30, 2005)	2,819	1,527	7,380	4,082
Marketing, general and administrative expenses (including non-cash stock compensation expense of \$1,262 and \$3,881 for the three and nine months ended September 30, 2006 and \$88 and (\$23) for the three and nine months ended September 30, 2005)	6,315	4,918	20,086	12,957
Legal expenses - patents	2,354	1,076	3,803	2,173
Inventor royalties and contingent legal fees expense - patents	2,623	3,939	12,741	5,706
Inventor royalties - V-chip	-	225	-	225
Amortization of patents	1,596	1,607	4,813	4,407
Write-off of patent-related intangible asset	-	-	297	-
Legal settlement credits	-	(211)	-	(406)
Loss from equity investments	253	100	786	202
<b>Total operating expenses</b>	<b>17,056</b>	<b>14,383</b>	<b>52,355</b>	<b>32,801</b>
<b>Operating loss</b>	<b>(6,788)</b>	<b>(6,137)</b>	<b>(19,962)</b>	<b>(17,084)</b>
<b>Other income (expense):</b>				
Interest and investment income	501	434	1,572	1,090
Loss on sale of interest in subsidiary	-	-	(84)	-
Warrant gains (charges)	913	163	663	163
<b>Total other income, net</b>	<b>1,414</b>	<b>597</b>	<b>2,151</b>	<b>1,253</b>



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Loss from continuing operations before income taxes and minority interests	(5,374)	(5,540)	(17,811)	(15,831)
(Provision) benefit for income taxes	(2)	98	(6)	232
Loss from continuing operations before minority interests	(5,376)	(5,442)	(17,817)	(15,599)
Minority interests	-	1	-	1
Loss from continuing operations	(5,376)	(5,441)	(17,817)	(15,598)
Discontinued operations:				
Estimated loss on disposal of discontinued operations	-	-	-	(210)
Net loss	(5,376)	(5,441)	(17,817)	(15,808)
Unrealized gains (losses) on short-term investments	70	(5)	73	2
Unrealized gains on foreign currency translation	2	14	6	36
Sale of interest in subsidiary's cumulative translation adjustment	-	-	(61)	-
Comprehensive loss	\$ (5,304)	\$ (5,432)	\$ (17,799)	\$ (15,770)
Earnings (loss) per common share:				
Attributable to the Acacia Technologies group:				
Loss from continuing operations	\$ (1,049)	\$ (1,558)	\$ (2,359)	\$ (4,982)
Basic and diluted loss per share	(0.04)	(0.06)	(0.09)	(0.19)
Loss from discontinued operations	\$ -	\$ -	\$ -	\$ (210)
Basic and diluted loss per share	-	-	-	(0.01)
Net loss	\$ (1,049)	\$ (1,558)	\$ (2,359)	\$ (5,192)
Basic and diluted loss per share	(0.04)	(0.06)	(0.09)	(0.20)
Attributable to the CombiMatrix group:				
Net loss	\$ (4,327)	\$ (3,883)	\$ (15,458)	\$ (10,616)
Basic and diluted loss per share	(0.11)	(0.12)	(0.39)	(0.33)
Weighted average shares:				
Acacia Research - Acacia Technologies stock:				
Basic and diluted	27,567,848	27,302,693	27,492,410	26,387,562
Acacia Research - CombiMatrix stock:				

Basic and diluted	40,209,640	33,239,726	39,411,421	31,887,872
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*The accompanying notes are an integral part of these consolidated financial statements.*

2

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**ACACIA RESEARCH CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(In thousands)  
(Unaudited)

	<b>For the Nine Months Ended</b>	
	<b>September 30,</b>	<b>September 30,</b>
	<b>2006</b>	<b>2005</b>
<b>Cash flows from operating activities:</b>		
Net loss	\$ (17,817)	\$ (15,808)
<b>Adjustments to reconcile net loss to net cash used in operating activities:</b>		
Depreciation and amortization	5,553	5,260
Minority interests	-	3
Non-cash stock compensation	4,678	(23)
Deferred income taxes	(70)	(210)
Non-cash warrant charges (gains)	(663)	(163)
Non-cash legal settlement charges (credits)	-	(406)
Loss on disposal of discontinued operations	-	210
Write-off of patent-related intangible asset	297	-
Loss from equity investments	786	253
Loss on sale of interest in subsidiary	84	-
Stock issued to consultant	94	-
Other	42	(128)
<b>Changes in assets and liabilities, excluding effect of business acquisition:</b>		
Accounts receivable	2,553	(986)
Prepaid expenses, inventory and other assets	(213)	(576)
Accounts payable and accrued expenses	2,285	574
Royalties and legal fees payable	(1,415)	1,331
Deferred revenues	(115)	375
Net cash used in operating activities from continuing operations	(3,921)	(10,294)
Net cash provided by (used in) operating activities from discontinued operations	222	(525)
Net cash used in operating activities	(3,699)	(10,819)
<b>Cash flows from investing activities:</b>		
Purchase of property and equipment	(619)	(1,162)
Purchase of available-for-sale investments	(14,927)	(57,309)
Sale of available-for-sale investments	27,485	59,260
Business acquisition (Note 7)	(16)	(5,796)
Purchase of additional interests in equity method investee	(1,400)	(1,100)
Patent acquisition costs	(1,020)	(445)
Sale of interest in subsidiary (net of cash disposed)	(369)	-
Net cash provided by (used in) investing activities	9,134	(6,552)
Net cash used in investing activities from discontinued operations	(353)	-
Net cash provided by (used in) investing activities	8,781	(6,552)
<b>Cash flows from financing activities:</b>		
Proceeds from sale of common stock, net of issuance costs	2,640	32,354
Prepaid Standby Equity Distribution Agreement commitment fees (Note 6)	(550)	-
Proceeds from the exercise of stock options	455	187

Net cash provided by financing activities	2,545	32,541
Effect of exchange rate on cash	-	35
Increase in cash and cash equivalents	7,627	15,205
Cash and cash equivalents, beginning	20,164	13,910
Cash and cash equivalents, ending	\$ 27,791	\$ 29,115

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

**ACACIA RESEARCH CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**1. DESCRIPTION OF BUSINESS AND BASIS OF PRESENTATION**

*Description of Business.* Acacia Research Corporation (“we,” “us” and “our”) is comprised of two operating groups.

*Acacia Technologies Group*

The Acacia Technologies group, a division of Acacia Research Corporation, develops, acquires, licenses and enforces patented technologies. The Acacia Technologies group owns and has rights to patent portfolios covering a wide range of technology areas. The Acacia Technologies group is primarily comprised of certain of Acacia Research Corporation’s direct and or indirect wholly owned subsidiaries and limited liability companies including:

- Acacia Global Acquisition Corporation
- Acacia Media Technologies Corporation
- Acacia Patent Acquisition Corporation
- Acacia Technologies Services Corporation
- AV Technologies LLC
- Broadcast Data Retrieval Corporation
- Broadcast Innovation LLC
- Computer Acceleration Corporation
- Computer Cache Coherency Corporation
- Computer Docking Station Corporation
- Credit Card Fraud Control Corporation
- Data Encryption Corporation
- Data Innovation LLC
- Diagnostic Systems Corporation
- Disk Link Corporation
- Financial Systems Innovation LLC
- High Resolution Optics Corporation
- Information Technology Innovation LLC
- InternetAd LLC
- IP Innovation LLC
- KY Data Systems LLC
- Micromesh Technology Corporation
- Microprocessor Enhancement Corporation
- New Medium LLC
- Peer Communications Corporation
- Product Activation Corporation
- Resource Scheduling Corporation
- Software Collaboration Corporation
- Soundview Technologies, Inc.
- Spreadsheet Automation Corporation
- TechSearch LLC
- Telematics Corporation
- VData LLC

The Acacia Technologies group also includes all corporate assets, liabilities, and related transactions of Acacia Research Corporation attributed to Acacia Research Corporation’s intellectual property licensing and enforcement business. Refer to “Business Acquisition” below for information on the Acacia Technologies group’s 2005 business acquisition activity.

*Business Acquisition.* On January 28, 2005, Acacia Global Acquisition Corporation acquired the assets of Global Patent Holdings, LLC, which owned 11 patent licensing companies (“GPH Acquisition”). The acquisition provided the Acacia Technologies group ownership of companies that control 27 patent portfolios, which include 120 U.S. patents and certain foreign counterparts, and cover technologies used in a wide variety of industries. Refer to Note 7 for a description of the acquisition transaction.

*CombiMatrix Group*

Our life sciences business, referred to as the “CombiMatrix group,” a division of Acacia Research Corporation, is comprised of our wholly owned subsidiary, CombiMatrix Corporation and CombiMatrix Corporation’s wholly owned subsidiary, CombiMatrix Molecular Diagnostics and includes all corporate assets, liabilities and transactions related to Acacia Research Corporation’s life sciences business.

The CombiMatrix group develops proprietary technologies and products and services in the areas of drug development, genetic analysis, nanotechnology research, defense and homeland security markets, and other markets where its products could be utilized. Among the technologies being developed by the CombiMatrix group is a platform technology to produce customizable arrays, which are semiconductor-based tools for use in identifying and determining the roles of genes, gene mutations and proteins. This technology has potential applications in the areas of genomics, proteomics, biosensors, drug discovery, drug development, diagnostics, combinatorial chemistry, material sciences and nanotechnology. Other technologies include proprietary molecular synthesis and screening methods for the discovery of potential new drugs. CombiMatrix Molecular Diagnostics, Inc., (“CMDX”), a wholly owned subsidiary located in Irvine, California, is exploring opportunities for the CombiMatrix group’s arrays in the field of molecular diagnostics. CombiMatrix K.K., a Japanese corporation located in Tokyo, Japan, has existed for the purpose of exploring opportunities for CombiMatrix Corporation’s array system with pharmaceutical and biotechnology companies in the Asian market. In January 2006, CombiMatrix Corporation sold 67% of its ownership interest in CombiMatrix K.K. to a third party. Refer to Note 12.

**ACACIA RESEARCH CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

*Other*

In January 2006, Acacia Research Corporation's board of directors approved a plan for its wholly owned subsidiary, CombiMatrix Corporation, to become an independent public company. The transaction is expected to be completed no sooner than the first quarter of 2007, subject, however, to determination that there are no significant negative tax consequences to Acacia Research Corporation or its shareholders and completing the required filings with the Securities and Exchange Commission, or SEC. We have received a private letter ruling from the IRS addressing certain tax implications of the transaction and have requested a tax opinion from counsel. If the conditions are met, Acacia Research Corporation will redeem all of the issued and outstanding shares of AR-CombiMatrix common stock for all of the common stock of CombiMatrix Corporation, which will register its common stock under the Securities and Exchange Act of 1934. Following the redemption, CombiMatrix Corporation will apply to list its shares for trading on a national exchange.

*Capital Structure.* On December 11, 2002, our stockholders voted in favor of a recapitalization transaction, which became effective on December 13, 2002, whereby we created two new classes of common stock called Acacia Research-CombiMatrix common stock ("AR-CombiMatrix stock") and Acacia Research-Acacia Technologies common stock ("AR-Acacia Technologies stock"), and divided our existing Acacia Research Corporation common stock into shares of the two new classes of common stock. AR-CombiMatrix stock is intended to reflect separately the performance of Acacia Research Corporation's CombiMatrix group. AR-Acacia Technologies stock is intended to reflect separately the performance of Acacia Research Corporation's Acacia Technologies group. Although the AR-CombiMatrix stock and the AR-Acacia Technologies stock are intended to reflect the performance of our different business groups, they are both classes of common stock of Acacia Research Corporation and are not stock issued by the respective groups.

**Liquidity and Risks**

*General.* To date, we and our subsidiaries have relied primarily upon selling equity securities and payments from our strategic partners and licensees to generate the funds needed to finance the implementation of our plans of operation for our subsidiaries.

Management believes that the Acacia Technologies group's cash and cash equivalent balances, anticipated cash flow from operations and other external sources of available credit will be sufficient to meet our cash requirements through at least November 2007.

Management believes that the CombiMatrix group's cash and cash equivalent balances, anticipated cash flows from operations and other external sources of available credit, including the standby equity distribution agreement (the "SEDA"), discussed at Note 6, will be sufficient to meet its cash requirements for the next six months.

*The Acacia Technologies Group.* To date, the Acacia Technologies group has relied upon the receipt of license fee payments from the licensing of the Acacia Technologies group's patented technologies and the selling of Acacia Research Corporation equity securities to generate the funds needed to finance the operations of the Acacia Technologies group. The Acacia Technologies group began to commercially license its DMT® technology in 2003. The GPH Acquisition provided the Acacia Technologies group with ownership of companies that control 27 patent portfolios, which include 120 U.S. patents and certain foreign counterparts, and cover technologies used in a wide variety of industries. Subsequent to the GPH Acquisition, the Acacia Technologies group has acquired or acquired the rights to over 20 additional patent portfolios, covering a wide range of technology areas, which it intends to develop, license and enforce.

There can be no assurance that the Acacia Technologies group will be able to implement its future plans. Failure by management to achieve its plans would have a material adverse effect on the Acacia Technologies group and on Acacia Research Corporation's ability to achieve its intended business objectives. We may be required to obtain additional financing. There can be no assurance that additional funding will be available on favorable terms, if at all. If we fail to obtain additional funding when needed, we may not be able to execute our business plans and our businesses may suffer.



**ACACIA RESEARCH CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

The timing of the receipt of revenues by the Acacia Technologies group's business operations are subject to certain risks and uncertainties, including:

- market acceptance of our patented technologies and services;
- business activities and financial results of our licensees;
- technological advances that may make our patented technologies obsolete or less competitive;
- increases in operating costs, including costs for legal services, engineering and research and personnel;
- the availability and cost of capital; and
- governmental regulation that may restrict the Acacia Technologies group's business.

The Acacia Technologies group's success also depends on its ability to protect its intellectual property. The Acacia Technologies group relies on its proprietary rights and their protection. Although reasonable efforts will be taken to protect the Acacia Technologies group's proprietary rights, the complexity of international trade secret, copyright, trademark and patent law, and common law, coupled with limited resources and the demands of quick delivery of technologies to market, create risk that these efforts will prove inadequate. Accordingly, if the Acacia Technologies group is unsuccessful with litigation to protect its intellectual property rights, the future revenues of the Acacia Technologies group could be adversely affected.

*The CombiMatrix Group.* The CombiMatrix group is deploying new and unproven technologies and continues to develop its commercial products. The CombiMatrix group has several ongoing long-term development projects that involve experimental technology and may require several years and substantial expenditures to complete. Management believes that the CombiMatrix group's cash and cash equivalent balances, anticipated cash flows from operations and other external sources of available credit including the SEDA will be sufficient to meet its cash requirements for the next six months. In order for the CombiMatrix group to continue as a going concern beyond March 31, 2007, the CombiMatrix group will be required to obtain capital from external sources, including the SEDA. However, based on the recent decline in the market value of AR-CombiMatrix stock, which began trading below \$1.00 per share in late September 2006, and due to the limitation of the number of shares of AR-CombiMatrix stock available on the SEDA, the CombiMatrix group may be required to seek additional sources of financing, including the issuance of debt and/or equity securities that may not be available at times and at terms acceptable to the CombiMatrix group. The issuance of equity securities will also cause dilution to the AR-CombiMatrix shareholders. If external financing sources beyond the SEDA are not available or are inadequate to fund the operations of the CombiMatrix group, it will be required to reduce its operating costs including research projects and personnel, which could jeopardize the future strategic initiatives and business plans of the CombiMatrix group. For example, reductions in research and development activities and/or personnel at our Mukilteo, Washington facility could result in the inability to invest the resources necessary to continue to develop next-generation products and improve existing product lines in order to remain competitive in the marketplace, resulting in reduced revenues and cash flows from the sales of our CustomArray products and services. Also, reduction in operating costs at our diagnostics subsidiary in Irvine, California, (CMDX), should they occur, could jeopardize its ability to launch, market and sell additional products and services necessary in order to grow and sustain its operations and eventually achieve profitability.

The ability to meet business objectives is dependent upon the CombiMatrix group's ability to raise additional financing, substantiate its technology and ultimately to fund itself from continuing operations. There can be no assurance that such funding will be available at acceptable terms or at all. The CombiMatrix group has a history of incurring net losses and net operating cash flow deficits.

The CombiMatrix group's business operations are also subject to certain risks and uncertainties, including:

- market acceptance of products and services;

- technological advances that may make its products and services obsolete or less competitive;
- increases in operating costs, including costs for supplies, personnel and equipment;
- the availability and cost of capital; and
- governmental regulation that may restrict its business.

Historically, the CombiMatrix group has been substantially dependent on arrangements with strategic partners and has relied upon payments by its partners for a significant component of its working capital. The CombiMatrix group intends to enter into additional strategic partnerships to develop and commercialize future products. However, there can be no assurance that the CombiMatrix group will be able to implement its future plans. Failure to achieve its plans would have a material adverse effect on the CombiMatrix group's and on Acacia Research Corporation's ability to achieve their intended business objectives. The CombiMatrix group also depends on its ability to protect its intellectual property; the loss thereof or the CombiMatrix group's failure to secure the issuance of additional patents covering elements of its business processes could materially harm its business and financial condition. The patents covering the CombiMatrix group's core technology begin to expire in 2018.

**ACACIA RESEARCH CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

The CombiMatrix group's products and services are concentrated in a highly competitive market that is characterized by rapid technological advances, frequent changes in customer requirements and evolving regulatory requirements and industry standards. Failure to anticipate or respond adequately to technological advances, changes in customer requirements, changes in regulatory requirements or industry standards, or any significant delays in the development or introduction of planned products or services, could have a material adverse effect on the CombiMatrix group's business and operating results.

Acacia Research Corporation's cash and cash equivalent and short term investment balances, cash flows and anticipated cash flows from operations and other sources of external credit, are attributed to the Acacia Technologies group and the CombiMatrix group based on the respective assets of the specific businesses comprising each group. Issuances of AR-Acacia Technologies stock (and the proceeds thereof) are attributed to the Acacia Technologies group and issuances of AR-CombiMatrix stock (and the proceeds thereof) are attributed to the CombiMatrix group. Neither of the groups is obligated to fund the ongoing operations of the other group. Management has no intent to use the cash and cash equivalent balances, anticipated cash flow from operations, and other external sources of available credit of one group to fund the ongoing operations of the other group.

*Basis of Presentation.* The accompanying unaudited consolidated financial statements include the accounts of Acacia Research Corporation and its wholly owned and majority-owned subsidiaries and investments accounted for under the equity method. Material intercompany transactions and balances have been eliminated in consolidation.

The accompanying consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, certain information and footnotes required by generally accepted accounting principles in annual financial statements have been omitted or condensed in accordance with quarterly reporting requirements of the SEC. These interim consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto for the year ended December 31, 2005, as reported by us in our Annual Report on Form 10-K. The year-end consolidated balance sheet data was derived from audited financial statements but does not include all disclosures required by accounting principles generally accepted in the United States of America.

The consolidated financial statements of Acacia Research Corporation include all adjustments of a normal recurring nature which, in the opinion of management, are necessary for a fair statement of our financial position as of September 30, 2006, and results of operations and cash flows for the interim periods presented. The results of operations for the three and nine months ended September 30, 2006, are not necessarily indicative of the results to be expected for the entire year.

*Separate Group Presentation.* AR-CombiMatrix stock and AR-Acacia Technologies stock are intended to reflect the separate performance of the respective division of Acacia Research Corporation. The CombiMatrix group and the Acacia Technologies group are not separate legal entities. Holders of AR-CombiMatrix stock and AR-Acacia Technologies stock are stockholders of Acacia Research Corporation. As a result, holders of AR-CombiMatrix stock and AR-Acacia Technologies stock continue to be subject to all of the risks of an investment in Acacia Research Corporation and all of its businesses, assets and liabilities. The assets of Acacia Research Corporation attributes to one of the groups could be subject to the liabilities of the other group. The group financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America, and taken together, comprise all the accounts included in the corresponding consolidated financial statements of Acacia Research Corporation. The financial statements of the groups reflect the financial position, results of operations, and cash flows of the businesses included therein. The financial statements of the groups include the accounts or assets of Acacia Research Corporation specifically attributed to the groups and were prepared using amounts included in Acacia Research Corporation's consolidated financial statements.

Minority interests represent participation of other stockholders in the net equity and in the division earnings and losses of the groups and are reflected in the caption "Minority interests" in the group financial statements. Minority interests adjust group net results of operations to reflect only the group's share of the division earnings or losses of non-wholly owned investees.

7

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**ACACIA RESEARCH CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

Financial effects arising from one group that affect Acacia Research Corporation's results of operations or financial condition could, if significant, affect the results of operations or financial condition of the other group and the market price of the class of common stock relating to the other group. Any division net losses of the CombiMatrix group or of the Acacia Technologies group, and dividends or distributions on, or repurchases of, AR-CombiMatrix stock or AR-Acacia Technologies stock, will reduce the assets of Acacia Research Corporation legally available for payment of dividends on AR-CombiMatrix stock or AR-Acacia Technologies stock.

## **2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

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

*Revision in the Classification of Certain Securities.* In connection with the preparation of the 2005 consolidated financial statements, Acacia Research Corporation concluded that it was appropriate to classify its annuity investments as current investments. Prior to 2005, such investments had been classified as cash and cash equivalents. Accordingly, we have made adjustments to our consolidated statement of cash flows for the nine months ended September 30, 2005, to reflect the gross purchases of these securities as investing activities rather than as a component of cash and cash equivalents. This change in classification does not affect previously reported cash flows from operations or from financing activities in our previously reported statements of cash flows, and it does not affect our previously reported statements of operations for any period.

As of September 30, 2005, before this revision in classification, \$4,933,000 of these current investments were classified as cash and cash equivalents on our consolidated balance sheet. There were no material purchases or sales of annuity investments during any of the periods presented, as such, the impact of the revision in classification on consolidated cash flows from investing activities was not material for any of the periods presented.

*Concentrations.* Two and three licensee(s) individually accounted for greater than 10% of the Acacia Technologies group's license fee revenues recognized during the three and nine months ended September 30, 2006, as compared to one licensee during the three and nine months ended September 30, 2005, respectively. Three and two licensees represented approximately 82% and 95% of the Acacia Technologies group's accounts receivable at September 30, 2006 and December 31, 2005, respectively.

Two and no customer(s) individually accounted for greater than 10% of the CombiMatrix group's product sales recognized during the three and nine months ended September 30, 2006, as compared to one and no customer(s) during the three and nine months ended September 30, 2005, respectively. Five and two customers represented approximately 89% and 84% of the CombiMatrix group's accounts receivable at September 30, 2006 and December 31, 2005, respectively.

*Stock-Based Compensation.* Effective January 1, 2006, Acacia Research Corporation adopted the provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123R"), which sets forth the accounting requirements for "share-based" compensation payments to employees and non-employee directors and requires that compensation cost relating to share-based payment transactions be recognized in the statement of operations. In March 2005, the SEC published Staff Accounting Bulletin No. 107 ("SAB 107"), which requires stock-based compensation to be classified in the same expense line items as cash compensation (i.e.

marketing, general and administrative and research and development expenses). The compensation cost for all stock-based awards is measured at the grant date, based on the fair value of the award, and is recognized as an expense over the employee's requisite service period (generally the vesting period of the equity award).

In addition, SFAS No. 123R requires stock-based compensation expense to be recorded only for those awards expected to vest using an estimated forfeiture rate. As such, SFAS No. 123R requires Acacia Research Corporation to estimate pre-vesting option forfeitures at the time of grant and reflect the impact of estimated pre-vesting option forfeitures on compensation expense recognized. Acacia Research Corporation considers several factors in connection with our estimates of pre-vesting forfeitures including types of awards, employee classification, and historical pre-vesting forfeiture data. Estimates of pre-vesting forfeitures must be periodically revised in subsequent periods if actual forfeitures differ from those estimates. To the extent that actual results differ from our estimates, such amounts will be recorded as cumulative adjustments in the period the estimates are revised. Prior to the adoption of SFAS No. 123R, Acacia Research Corporation accounted for forfeitures as they occurred under the pro forma disclosure provisions of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation." All references to stock-based compensation expense in these notes, upon adoption of SFAS No. 123R, refers to stock-based compensation net of estimated forfeitures, as required by SFAS No. 123R.

**ACACIA RESEARCH CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

We adopted SFAS No. 123R using the modified prospective transition method. Under this transition method, compensation cost recognized for the nine months ended September 30, 2006 includes: (i) compensation cost for all stock-based awards 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 No. 123 and previously presented in the pro forma footnote disclosures), and (ii) compensation cost for all stock-based awards granted subsequent to January 1, 2006 (based on the grant-date fair value estimated in accordance with the new provisions of SFAS No. 123R). The cumulative effect of applying an estimated forfeiture percentage to stock-based payments granted prior to, but not yet vested as of, January 1, 2006 was not material.

Prior to January 1, 2006, Acacia Research Corporation accounted for share-based compensation to employees in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25"), and related interpretations. Acacia Research Corporation also followed the disclosure requirements of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS No. 123"), as amended by Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure." Because Acacia Research Corporation previously adopted only the pro forma disclosure provisions of SFAS No. 123, we will recognize compensation cost relating to the unvested portion of awards granted prior to the date of adoption using the same estimate of the grant-date fair value and the same attribution method used to determine the pro forma disclosures under SFAS No. 123, except that forfeiture rates will be estimated for all awards, as required by SFAS No. 123R. In accordance with the requirements of the modified prospective transition method of adoption of SFAS No. 123R, the financial statement amounts for prior periods presented in this Form 10-Q have not been restated to reflect the fair value method of recognizing compensation cost relating to stock-based awards.

The fair value of each option award is estimated on the date of grant using a Black-Scholes option valuation model that uses the assumptions noted in the table below. Expected volatility is based on the separate historical volatility of the market prices of the AR-CombiMatrix stock and AR-Acacia Technologies stock. Volatilities of peer companies were also considered, when applicable, to address the lack of extensive historical volatility data for Acacia Research Corporation's classes of common stock. The risk-free rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of grant. The expected term assumption was determined in accordance with guidance set forth in SAB 107, which provides a "simplified method" for estimating the expected term for stock options, granted prior to December 31, 2007, that 1) are granted at-the-money, 2) have exercisability conditioned only on completion of a service condition through the vesting date, 3) require that employees who terminate their service prior to vesting must forfeit the options, 4) provide that employees who terminate their service after vesting are granted limited time to exercise their stock options (typically 30-90 days), and 5) are nontransferable and nonhedgeable. The simplified method is based on the vesting period and the contractual term for each grant, or for each vesting-tranche for awards with graded vesting. The mid-point between the vesting commencement date and the expiration date is used as the expected term under this method. For awards with multiple vesting-tranches, the times from grant until these mid-points for each of the tranches were averaged to provide an overall expected term.

The fair value of restricted stock awards is determined by the product of the number of shares granted and the grant date market price of the AR-Acacia Technologies stock or AR-CombiMatrix stock.

The fair value of share-based awards is expensed on a straight-line basis over the requisite service period (generally the vesting period of the award), which is generally two to four years.

The fair value of stock options was estimated using the Black-Scholes option-pricing model based on the following weighted average assumptions:





**ACACIA RESEARCH CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

	<b>Risk Free Interest Rate</b>	<b>Term</b>	<b>Volatility</b>	<b>Dividends</b>
<b>For the Three Months Ended September 30, 2006 <sup>(1)</sup></b>				
AR-CombiMatrix stock	5.10%	6 years	82%	0%
CMDX stock	5.00%	6.25 years	82%	0%
<b>For the Nine Months Ended September 30, 2006</b>				
AR-CombiMatrix stock	5.06%	6 years	82%	0%
AR-Acacia Technologies stock	4.30%	6 years	75%	0%
CMDX stock	5.07%	6.25 years	82%	0%

(1) No AR - Acacia Technologies stock options were granted during the three months ended September 30, 2006.

The following table illustrates the impact of share-based compensation expense on reported amounts (in thousands, except for per share data):

	<b>For the Three Months Ended September 30, 2006</b>		<b>For the Nine Months Ended September 30, 2006</b>	
	<b>As Reported</b>	<b>Impact of Stock Based Compensation</b>	<b>As Reported</b>	<b>Impact of Stock Based Compensation</b>
Loss from continuing operations before income taxes	\$ (5,374)	\$ (1,310)	\$ (17,811)	\$ (3,789)
Net loss	(5,376)	(1,310)	(17,817)	(3,789)
<b>Loss per share:</b>				
<b>AR-Acacia Technologies stock:</b>				
Stock-based compensation	\$ -	\$ (702)	\$ -	\$ (2,072)
Basic and diluted	\$ (0.04)	\$ (0.03)	\$ (0.09)	\$ (0.08)
<b>AR-CombiMatrix stock:</b>				
Stock-based compensation	\$ -	\$ (608)	\$ -	\$ (1,717)
Basic and diluted	\$ (0.11)	\$ (0.02)	\$ (0.39)	\$ (0.04)

Stock-based compensation expense for the three and nine months ended September 30, 2006 and 2005 is included in research and development expenses and marketing, general and administrative expenses, as disclosed in the accompanying consolidated statement of operations and comprehensive income (loss).

Awards granted prior to Acacia Research Corporation's implementation of SFAS No. 123R were accounted for under the recognition and measurement principles of APB No. 25 and related interpretations. Accordingly, no stock-based employee compensation cost was reflected in the accompanying unaudited consolidated statements of operations for the three and nine months ended September 30, 2005, because all options granted under Acacia Research Corporation's plans had exercise prices equal to the market value of the underlying common stock on the date of grant.

The following table illustrates the pro forma effect on net loss and loss per share, if Acacia Research Corporation had applied the fair value recognition provisions of SFAS No. 123 (in thousands, except per share data):

	<b>AR-Acacia Technologies Stock</b>		<b>AR-Acacia CombiMatrix Stock</b>	
	<b>Three Months</b>	<b>Nine Months</b>	<b>Three Months</b>	<b>Nine Months</b>
	<b>Ended</b>	<b>Ended</b>	<b>Ended</b>	<b>Ended</b>
	<b>September 30,</b>	<b>September 30,</b>	<b>September 30,</b>	<b>September 30,</b>
	<b>2005</b>	<b>2005</b>	<b>2005</b>	<b>2005</b>
Loss from continuing operations, as reported	\$ (1,558)	\$ (5,192)	\$ (3,883)	\$ (10,616)
Add: Stock-based compensation, intrinsic value method reported in net loss, net of tax <sup>(3)</sup>	-	123	-	-
Deduct: Pro forma stock-based compensation fair value method <sup>(2)</sup>	(726)	(1,945)	(870)	(2,549)
Loss from continuing operations, pro forma	\$ (2,284)	\$ (7,014)	\$ (4,753)	\$ (13,165)
Basic and diluted loss per share from operations, as reported	\$ (0.06)	\$ (0.20)	\$ (0.12)	\$ (0.33)
Basic and diluted loss per share from operations, pro forma	\$ (0.08)	\$ (0.27)	\$ (0.14)	\$ (0.41)
<b>Weighted Average Assumptions used <sup>(1)</sup></b>				
Risk free interest rate	3.96%	3.76%	3.97%	3.83%
Volatility	94%	94%	88%	88%
Expected term	5 years	5 years	5 years	5 years

(1) The fair value of stock options was determined using the Black-Scholes option-pricing model. The fair value calculations assume no expected dividends.

(2) The previously reported 2005 pro forma income (loss) from operations and related pro forma earnings (loss) per share amounts have been revised for a computational error in the amortization of stock compensation expense and to reflect amounts with a 0% effective tax rate due to the full valuation allowance recoded by Acacia Research Corporation for all periods presented and to exclude stock compensation expense related to non-employees.

(3) Includes the impact of non-cash stock compensation expense related to restricted stock grants. The pro forma impact on net income (loss) and earnings (loss) per share of options outstanding under the CombiMatrix Molecular Diagnostics, Inc. Plan was not material.

**ACACIA RESEARCH CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

SFAS No. 123R does not require the recording of deferred stock compensation charges in stockholder's equity on the grant date of a stock based award. As such, in accordance with SFAS No. 123R, all deferred stock compensation charges recorded under APB No. 25, totaling \$1,400,000 at December 31, 2005, have been reversed upon adoption of SFAS No. 123R, with a corresponding reduction being recorded in consolidated additional paid-in capital.

### 3. EARNINGS (LOSS) PER SHARE

*Earnings (Loss) Per Share.* Basic earnings per share for each class of common stock is computed by dividing the income or loss allocated to each class of common stock by the weighted average number of outstanding shares of that class of common stock. Diluted earnings per share is computed by dividing the income allocated to each class of common stock by the weighted average number of outstanding shares of that class of common stock including the dilutive effect of potential common shares, computed using the treasury method. Potential common shares primarily consist of employee stock options and unvested restricted stock grants.

The earnings or losses allocated to each class of common stock are determined by Acacia Research Corporation's board of directors. This determination is generally based on the net income or loss amounts of the corresponding group determined in accordance with accounting principles generally accepted in the United States of America. Acacia Research Corporation believes this method of allocation is systematic and reasonable. The Acacia Research Corporation board of directors can, at its discretion, change the method of allocating earnings or losses to each class of common stock at any time.

Weighted average share information for the periods presented was as follows:

	<b>For the Three Months Ended</b>		<b>For the Nine Months Ended</b>	
	<b>September 30,</b>	<b>September 30,</b>	<b>September 30,</b>	<b>September 30,</b>
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
<b>Acacia Research - Acacia Technologies stock</b>				
Basic and diluted weighted average number of common shares outstanding	27,567,848	27,302,693	27,492,410	26,387,562
All outstanding stock awards excluded from the computation of diluted loss per share because the effect of inclusion would have been anti-dilutive	6,520,052	6,201,869	6,520,052	6,201,869
<b>Acacia Research - CombiMatrix stock</b>				
Basic and diluted weighted average number of common shares outstanding	40,209,640	33,239,726	39,411,421	31,887,872
All outstanding stock options excluded from the computation of diluted loss per share because the	8,557,557	6,981,677	8,557,557	6,981,677

effect of inclusion would have been anti-dilutive

Outstanding stock options under the CombiMatrix Molecular Diagnostics 2005 Stock Award Plan, as disclosed at Note 9, have also been excluded from the computation of diluted loss per share because the effect of inclusion would have been anti-dilutive.

#### 4. GOODWILL AND INTANGIBLES

The Acacia Technologies group had \$121,000 of goodwill at September 30, 2006, and December 31, 2005. The CombiMatrix group had \$16,918,000 and \$18,859,000 of goodwill at September 30, 2006, and December 31, 2005, respectively.

Acacia Research Corporation's identifiable intangible assets at September 30, 2006, and December 31, 2005, are comprised of patents and patent rights. The gross carrying amounts and accumulated amortization as of September 30, 2006, and December 31, 2005, related to patents and patent rights, by segment, are as follows (in thousands):

	<b>Acacia Technologies Group</b>		<b>CombiMatrix Group</b>		<b>Consolidated</b>	
	<b>September 30, 2006</b>	<b>December 31, 2005</b>	<b>September 30, 2006</b>	<b>December 31, 2005</b>	<b>September 30, 2006</b>	<b>December 31, 2005</b>
Gross carrying amount - patents	\$ 30,307	\$ 30,392	\$ 12,095	\$ 12,095	\$ 42,402	\$ 42,487
Accumulated amortization	(10,480)	(6,606)	(4,991)	(4,169)	(15,471)	(10,775)
Patents, net	\$ 19,827	\$ 23,786	\$ 7,104	\$ 7,926	\$ 26,931	\$ 31,712

**ACACIA RESEARCH CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

The Acacia Technologies group and the CombiMatrix group's patents have remaining estimated economic useful lives up to 2013 and 2020, respectively. The weighted average remaining estimated economic useful life of the Acacia Technologies group's patents is 5 years. The weighted average remaining estimated economic useful life of the CombiMatrix group's patents is 9 years. Annual aggregate amortization expense for each of the five fiscal years through December 31, 2010 is estimated to be \$5,272,000 in 2006, \$5,235,000 in 2007, \$3,912,000 in 2008, \$3,461,000 in 2009 and \$3,270,000 in 2010 for the Acacia Technologies group and \$1,095,000 per year for the CombiMatrix group. At September 30, 2006, and December 31, 2005, all of our acquired intangible assets other than goodwill were subject to amortization.

For the nine months ended September 30, 2006, the Acacia Technologies group incurred patent acquisition costs totaling \$1,020,000 in connection with the acquisition of the rights to several additional patent portfolios. The acquired patents and patent rights have estimated economic useful lives ranging from five to seven years. Refer to Note 7 for additions to patent related intangibles during the nine months ended September 30, 2005.

In June 2006, the Acacia Technologies group recorded a non-cash charge of \$297,000, related to the write-off of a patent-related intangible asset. We review long-lived assets and intangible assets for potential impairment when events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. In the event the sum of the expected undiscounted future cash flows resulting from the use of the asset is less than the carrying amount of the asset, an impairment loss equal to the excess of the asset's carrying value over its fair value is recorded. During the second quarter of 2006, pursuant to the terms of the respective license agreement, management elected to terminate its rights to exclusively license and enforce the patent, resulting in the write-off of the remaining carrying value of the patent-related intangible asset as of June 30, 2006.

As of March 31, 2006, the CombiMatrix group reduced its goodwill and deferred tax liability balances by \$1,941,000, which were initially recorded in fiscal 2000, to properly reflect the reduction in its income tax valuation allowance after consideration of the deferred tax liability. As of March 31, 2006, the Acacia Technologies group reduced its patents and deferred tax liability by \$691,000, which were initially recorded in fiscal 2002, to properly reflect the reduction in its income tax valuation allowance after consideration of the deferred tax liability.

## **5. RECENT ACCOUNTING PRONOUNCEMENTS**

In July 2006, the FASB issued Interpretation No. 48 ("FIN 48"), "Accounting for Uncertainty in Income Taxes," which clarifies the accounting for uncertainty in income taxes recognized in the financial statements in accordance with FASB Statement No. 109, "Accounting for Income Taxes." FIN 48 provides guidance on the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosures, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. We are currently evaluating the impact of this standard, if any, on our consolidated and separate group financial position, results of operations and cash flows.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108 ("SAB 108"), "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements." SAB 108 is effective for fiscal years ending on or after November 15, 2006 and addresses how financial statement errors should be considered from a materiality perspective and corrected. The literature provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. Historically there have been two common approaches used to quantify such errors: (i) the "rollover" approach, which quantifies the error as the amount by which the current year income statement is misstated, and (ii) the "iron curtain"

approach, which quantifies the error as the cumulative amount by which the current year balance sheet is misstated. The SEC Staff believes that companies should quantify errors using both approaches and evaluate whether either of these approaches results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. Historically, we have evaluated uncorrected differences utilizing the “rollover” approach, and we are currently evaluating the impact, if any, of adopting the provisions of SAB 108 on our consolidated and separate group financial position, results of operations and cash flows.

In September 2006, the FASB issued SFAS No. 157, “Fair Value Measurements” (“SFAS No. 157”). SFAS No. 157 establishes a common definition for fair value to be applied to US GAAP guidance requiring use of fair value, establishes a framework for measuring fair value, and expands disclosure about such fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. We are currently assessing the impact, if any, of adopting SFAS No. 157 on our consolidated and separate group financial position, results of operations and cash flows.

**ACACIA RESEARCH CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**6. EQUITY FINANCING**

On June 14, 2006, Acacia Research Corporation entered into a standby equity distribution agreement (the “SEDA”) with Cornell Capital Partners, LP (“Cornell”). Under the terms of the SEDA, Acacia Research Corporation can require Cornell to purchase up to \$50.0 million of AR-CombiMatrix common stock, or up to 13,024,924 shares, over a two-year period following the effective date of the SEDA. Such shares will be in the form of registered securities drawn from Acacia Research Corporation’s current shelf registration statement. All proceeds from each advance will be contributed to the CombiMatrix group. Acacia Research Corporation can request advances under the SEDA in up to \$5.0 million increments. At the closing of each advance, which will take place six days after the initial notification to Cornell, Acacia Research Corporation will issue to Cornell a number of shares of AR-CombiMatrix common stock equal to the amount of the advance divided by the lowest daily volume weighted average price (“VWAP”) of AR-CombiMatrix common stock during the five trading days following the advance notice to Cornell, which will purchase the shares at 97.5% of the VWAP. Management can also specify a floor price whereby shares that trade below this price during the five-day trading period will be excluded from determining the VWAP. At each closing, Acacia Research Corporation will pay an underwriting fee of 4% of the gross amount of each advance on the first \$20.0 million and 5% of the gross proceeds of each advance on the remaining \$30.0 million of the SEDA to Cornell. Acacia Research Corporation is not obligated to request any advances under the agreement and will not pay any additional fees to Cornell so long as no advances are requested. The SEDA is also cancelable by Acacia Research Corporation at any time, without penalty. Acacia Research Corporation may not request advances if the shares to be issued in connection with such advances would result in Cornell owning more than 9.9% of the outstanding AR-CombiMatrix common stock. A total of 13,024,924 shares of AR-CombiMatrix common stock are authorized to be issued under the SEDA.

Upon closing of the SEDA, the CombiMatrix group paid Cornell a one-time commitment fee of \$550,000 and an additional \$20,000 in due diligence and other closing-related costs. The \$550,000 fee was recorded as a long-term asset and will be amortized against future advances as costs of equity issuances. On June 23 2006, Cornell purchased 343,750 shares of AR-CombiMatrix common stock at \$1.60 per share (which was not an advance under the SEDA), based on the fair value of AR-CombiMatrix stock on June 12, 2006. The shares of AR-CombiMatrix stock were offered pursuant to an effective registration statement previously filed with the Securities and Exchange Commission. Since executing the SEDA through September 30, 2006, Acacia Research Corporation has requested three advances from Cornell to purchase a total of 2,019,646 shares of AR-CombiMatrix stock at prices ranging from \$1.16 to \$1.13 per share, resulting in net proceeds of \$2,207,000 contributed to the CombiMatrix group. Subsequent to September 30, 2006 through November 2, 2006, an additional 1,191,699 shares of AR-CombiMatrix stock at prices ranging from \$0.98 to \$0.73 per share have been sold to Cornell, generating net proceeds of \$863,000 contributed to the CombiMatrix group. As of November 2, 2006, 9,813,579 shares of AR-CombiMatrix common stock remain available under the SEDA.

In February 2005, Acacia Research Corporation raised gross proceeds of \$19,600,000 through the sale of 3,500,000 shares of AR-Acacia Technologies stock at a price of \$5.60 per share in a registered direct offering. Net proceeds raised of approximately \$19,532,000, which are net of related issuance costs, were attributed to the Acacia Technologies group. The shares of AR-Acacia Technologies stock were offered pursuant to an effective registration statement previously filed with the Securities and Exchange Commission.

**7. ACQUISITION**

On January 28, 2005, Acacia Global Acquisition Corporation, a wholly owned subsidiary of Acacia Research Corporation, acquired substantially all of the assets of Global Patent Holdings, LLC, a privately held patent holding

company based in Northbrook, Illinois, which owned 11 patent licensing companies. The acquisition provided the Acacia Technologies group 100% ownership of companies that control 27 patent portfolios, which include 120 U.S. patents and certain foreign counterparts, and cover technologies used in a wide variety of industries. As a result of the acquisition, we have expanded and diversified the Acacia Technologies group's potential revenue generating activities.



**ACACIA RESEARCH CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

The acquisition was accounted for in accordance with the purchase method of accounting. Under the purchase method of accounting, the purchase consideration is allocated to the assets acquired, including tangible assets, patents and other identifiable intangibles and liabilities assumed, based on their estimated fair values at the date of acquisition. The consolidated statement of operations includes the results of the acquired companies beginning on January 28, 2005, the date of acquisition. The aggregate purchase consideration was approximately \$25,105,000, including \$5.0 million of cash, the issuance of 3,938,832 shares of AR-Acacia Technologies stock valued at \$19,293,000 (net of estimated common stock registration costs of \$228,000) and acquisition costs, including registration costs, of \$812,000. The value of the common shares issued was determined based on the average market price of AR-Acacia Technologies stock, as reported on NASDAQ, over the 5-day period (December 13 - December 17, 2004) before and after the terms of the acquisition were agreed to and announced.

The following table summarizes the total purchase consideration and the allocation of the consideration paid to the estimated fair value of the assets acquired and liabilities assumed (in thousands):

<b>Purchase Consideration:</b>	
Cash paid	\$ 5,000
Fair value of AR-Acacia Technologies stock issued <sup>(1)</sup>	19,293
Acquisition and registration costs	812
<b>Total purchase consideration</b>	<b>\$ 25,105</b>
 <b>Purchase Price Allocation:</b>	
Estimated fair value of net tangible assets acquired at January 28, 2005	\$ (26)
Intangible assets acquired - patents and patent rights <sup>(1)</sup>	25,131
<b>Total</b>	<b>\$ 25,105</b>

(1) Reflects non-cash investing activity.

Management was primarily responsible for determining the fair value of the tangible and identifiable intangible assets acquired and liabilities assumed at the date of acquisition. Management considered a number of factors in estimating the fair value of the intangible assets acquired, including reference to an independent valuation. The patents and patent rights acquired were valued using a discounted cash flow model on a patent portfolio by portfolio basis, which estimated the future net cash flows expected to result from the licensing of each portfolio, taking into account potential infringers of the patents, usage of the underlying technologies, estimated license fee revenues, contingent legal fee arrangements, royalties due to former patent holders, other estimated costs, tax implications and other factors. A discount rate consistent with the risks associated with achieving the estimated net cash flows was used to estimate the present value of future estimated net cash flows. Management's valuation resulted in an estimated fair value of patent related assets acquired of approximately \$27,000,000, resulting in approximately \$1,900,000 of excess fair value over the cost of net assets acquired, which has been allocated as a pro rata reduction to the amounts that otherwise would have been assigned to the assets acquired, in accordance with the purchase method of accounting.

Amounts attributable to patents and patent rights acquired are amortized using the straight-line method over the estimated economic useful lives of the underlying patents which range from two to seven years. At the date of acquisition, the estimated weighted average useful life of amortizable patent related intangibles acquired was approximately 6 years.

In connection with the acquisition described above, Acacia Global Acquisition Corporation entered into a consulting agreement with the former CEO of Global Patent Holdings, LLC who, as a result of the acquisition transaction, is also

a shareholder of Acacia Research Corporation. The agreement requires the payment of \$2,000,000 in consulting fees over a two-year period, and certain reimbursable consulting related expenses, commencing on the date of acquisition. Marketing, general and administrative expenses for the three and nine months ended September 30, 2006 include \$272,000 and \$816,000, respectively, in expenses related to the consulting agreement. Marketing, general and administrative expenses for the three and nine months ended September 30, 2005 include \$274,000 and \$738,000, respectively, in expenses related to the consulting agreement. Consulting services to be performed consist primarily of consultation on intellectual property matters associated with the patents and patent rights acquired in the transaction. The consulting fees are being expensed in the consolidated statement of operations as the consulting services are rendered during the two-year term of the consulting agreement. Acacia Global Acquisition Corporation may terminate the consulting agreement for cause as provided for in the agreement. The consulting agreement also contains certain automatic termination provisions, including; the failure by Acacia Global Acquisition Corporation to make timely consulting payments in accordance with the agreement; a significant decrease in working capital of Acacia Research Corporation, as defined in the agreement; material breach of the agreement by Acacia Global Acquisition Corporation; and the death of the consultant. Any occurrence of these conditions may require the payment of all remaining consulting fees outstanding under the agreement within thirty days of the occurrence of the termination event. Acacia Research Corporation also executed an agreement guaranteeing Acacia Global Acquisition Corporation's performance of its obligations under the consulting agreement.

**ACACIA RESEARCH CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

The acquisition was treated for tax purposes as a taxable asset acquisition and, as such, Acacia Research Corporation did not record any book/tax basis differences and thus, no deferred income taxes were recorded in connection with the application of the purchase method of accounting. Differences between the book and tax amortization period for amounts allocated to patented related intangibles give rise to deferred tax assets.

**8. COMMON STOCK PURCHASE WARRANT LIABILITY**

Acacia Research Corporation's classes of common stock are subject to certain redemption provisions in the event that Acacia Research Corporation sells, transfers, assigns or otherwise disposes of, in one transaction or a series of related transactions, all or substantially all of the properties and assets attributed to either group.

Acacia Research Corporation adopted FASB Staff Position No. 150-5 ("FSP No. 150-5"), effective July 1, 2005, which requires that warrants for shares that are redeemable be classified as liabilities, based on the fair values of the warrants, which are required to be marked to market at each balance sheet date. The fair value of contingently redeemable AR-CombiMatrix stock purchase warrants outstanding at September 30, 2006 and December 31, 2005 was \$719,000 and \$1,381,000, respectively. Net warrant gains for the three and nine months ended September 30, 2006, reflected in other income (expense), related to changes in the fair value of the warrant liability totaled \$913,000 and \$663,000, respectively. Net warrant gains for the three and nine months ended September 30, 2005 totaled \$163,000.

The fair value of AR-CombiMatrix stock purchase warrants was determined using the Black-Scholes option-pricing model, assuming weighted average risk free interest rates over the remaining term of the warrants of approximately 4.35% in December 2005 and 4.71% (two-year) and 4.62% (four year) in September 2006, volatility over the remaining term of the warrants of 84% in December 2005 and 79% and 82% in September 2006, and remaining terms of two to four years.

**9. STOCK BASED COMPENSATION PLANS**

The 2002 Acacia Technologies Stock Incentive Plan (the "AR-Acacia Technologies Group Plan") and the 2002 CombiMatrix Stock Incentive Plan (the "AR-CombiMatrix Group Plan") were approved by the stockholders of Acacia Research Corporation in December 2002. The AR-Acacia Technologies Group Plan authorizes grants of stock options, stock awards and performance shares with respect to AR-Acacia Technologies stock. The AR-CombiMatrix Group Plan authorizes grants of stock options, stock awards and performance shares with respect to AR-CombiMatrix stock. Directors and certain officers and key employees with responsibilities involving both the Acacia Technologies group and the CombiMatrix group may be granted awards under both incentive plans in a manner which reflects their responsibilities. The board of directors believes that granting participants awards tied to performance of the group in which the participants work and, in certain cases the other group, is in the best interest of the Acacia Research Corporation and its stockholders. The terms of the AR-Acacia Technologies Group Plan and the AR-CombiMatrix Group Plan are identical except that AR-Acacia Technologies stock may be issued only under the AR-Acacia Technologies Group Plan and AR-CombiMatrix stock may be issued only under the AR-CombiMatrix Group Plan.

Acacia Research Corporation's compensation committee administers the discretionary option grant and stock issuance programs. This committee determines which eligible individuals are to receive option grants or stock issuances under those programs, the time or times when the grants or issuances are to be made, the number of shares subject to each grant or issuance, the status of any granted option as either an incentive stock option or a non-statutory stock option under the federal tax laws, the vesting schedule to be in effect for the option grant or stock issuance and the maximum

term for which any granted option is to remain outstanding. The exercise price of options is generally equal to the fair market value of the AR-CombiMatrix stock or AR-Acacia Technologies stock on the date of grant. Options generally begin to be exercisable six months to one year after grant and generally expire ten years after grant. Stock options generally vest over three to four years and restricted shares generally vest in full after two years (represents the requisite service period under SFAS No. 123R).

**ACACIA RESEARCH CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

The authorized number of shares of common stock subject to the AR-Acacia Technologies Group Plan is 7,208,000 shares. The authorized number of shares of common stock subject to the AR-CombiMatrix Group Plan is 10,910,000 shares. The number of shares of common stock available for issuance under the AR-Acacia Technologies Group Plan and the AR-CombiMatrix Group Plan automatically increases on the first trading day of January each calendar year during the term of the Plan by an amount equal to three percent (3%) of the total number of shares of common stock outstanding on the last trading day in December of the immediately preceding calendar year, but in no event shall any such annual increase exceed 500,000 shares for the AR-Acacia Technologies Group Plan and 600,000 shares for the AR-CombiMatrix Group Plan. The aggregate number of shares of common stock available for issuance under either Plan shall not exceed 20,000,000 shares. At September 30, 2006, shares available for grant are 53,427 and 1,038,872 under the AR-Acacia Technologies Group Plan and the AR-CombiMatrix Group Plan, respectively. The AR-Acacia Technologies Group Plan and the AR-CombiMatrix Group Plan do not segregate the number of securities remaining available for future issuance among stock options and other awards. The shares authorized for future issuance represents the total number of shares available through any combination of stock options or other awards. Upon the exercise of stock options or the granting of restricted stock, it is Acacia Research Corporation's policy to issue new shares of the respective class of common stock.

A summary of option activity under our stock option plans for the nine months ended September 30, 2006 is as follows:

<i>AR-CombiMatrix Stock:</i>	<b>Options</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted Average Remaining Contractual Term</b>	<b>Aggregate Intrinsic Value</b>
Outstanding at December 31, 2005	6,925,000	\$6.82		
Granted	1,834,000	\$1.41		
Exercised	-	-		
Forfeited	(95,000)	\$3.11		
Expired	(106,000)	\$6.72		
Outstanding at September 30, 2006	8,558,000	\$5.70	6.5 years	-
Vested and Exercisable at September 30, 2006	6,185,000	\$7.13	5.4 years	-

The weighted average grant date fair value of stock options granted during the three and nine months ended September 30, 2006 was \$1.02, and during the three and nine months ended September 30, 2005 was \$1.38 and \$2.09, respectively. No AR-CombiMatrix options were exercised during the three and nine months ended September 30, 2006. The total intrinsic value of options exercised during the three and nine months ended September 30, 2005 was not material. The fair value of options vested during the three and nine months ended September 30, 2006 was \$486,000 and \$2,138,000, respectively, and during the three and nine months ended September 30, 2005 was \$686,000 and \$2,327,000, respectively. As of September 30, 2006, the total unrecognized compensation expense related to nonvested stock option awards was \$2,932,000, which is expected to be recognized over a weighted average term of approximately one year.

<i>AR-Acacia Technologies Stock:</i>	<b>Options</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted Average Remaining</b>	<b>Aggregate Intrinsic Value</b>
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**Contractual  
Term**

Outstanding at December 31, 2005	5,977,000	\$7.64		
Granted	465,000	\$7.75		
Exercised	(216,000)	\$2.11		
Forfeited	(94,000)	\$6.12		
Outstanding at September 30, 2006	6,132,000	\$7.87	5.9 years	\$31,224,000
Vested and Exercisable at September 30, 2006	4,866,000	\$8.43	5.3 years	\$24,069,000

The weighted average grant date fair value of stock options granted during the nine months ended September 30, 2006 was \$5.35 (no AR-Acacia Technologies stock options were granted during the three months ended September 30, 2006) and for the three and nine months ended September, 30, 2005 was \$3.73 and \$4.04, respectively. The total intrinsic value of options exercised during the three and nine months ended September 30, 2006 was \$583,000 and \$1,980,000, respectively, and during the three and nine months ended September 30, 2005 was \$141,000 and \$231,000, respectively. The fair value of options vested during the three and nine months ended September 30, 2006 was \$950,000 and \$2,825,000, respectively, and during the three and nine months ended September 30, 2005 was \$399,000 and \$1,156,000, respectively. As of September 30, 2006, the total unrecognized compensation expense related to nonvested stock option awards was \$3,444,000, which is expected to be recognized over a weighted average term of approximately two years.

**ACACIA RESEARCH CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

A summary of the status of AR-Acacia Technologies nonvested restricted shares as of September 30, 2006, and changes during the nine months ended September 30, 2006, is as follows:

<i>AR-Acacia Technologies Stock:</i>	<b>Nonvested Restricted Shares</b>	<b>Weighted Average Grant Date Fair Value</b>
Nonvested restricted stock at December 31, 2005	338,000	\$5.07
Granted	102,000	\$10.82
Vested	(30,000)	\$7.16
Forfeited	(23,000)	\$6.75
Nonvested restricted stock at September 30, 2006	387,000	\$6.33

As of September 30, 2006, the total unrecognized compensation expense related to nonvested restricted stock awards was \$1,405,000, which is expected to be recognized over a weighted average period of approximately one year. The total fair value of shares vested during the three and nine months ended September 30, 2006 was \$0 and \$215,000, respectively. There are no restricted share grants outstanding under the AR-CombiMatrix Group Plan.

At September 30, 2006, Acacia Research Corporation and its separate operating groups continue to record a full valuation allowance against its deferred tax assets due to management's determination that the criteria for recognition have not been met. As such, the implementation and subsequent accounting for stock based awards under SFAS No. 123R did not have an impact on Acacia Research Corporation's or the separate group's deferred taxes or related tax provisions for the periods presented.

**CombiMatrix Molecular Diagnostics 2005 Stock Award Plan**

CombiMatrix Corporation's wholly owned subsidiary, CMDX, executed the CombiMatrix Molecular Diagnostics 2005 Stock Award Plan (the "CMDX Plan") with plan provisions and terms similar to that of the AR-CombiMatrix Group Plan, as described above. The authorized number of shares of common stock subject to the CMDX Plan is 4,000,000 shares. At September 30, 2006, shares available for grant under the CMDX Plan are 2,150,000. A summary of option activity under CMDX Plan for the nine months ended September 30, 2006 is as follows:

<i>CMDX Stock:</i>	<b>Options</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted Average Remaining Contractual Term</b>	<b>Aggregate Intrinsic Value</b>
Outstanding at December 31, 2005	1,692,000	\$0.10		
Granted	910,000	\$0.50		
Exercised	-	-		
Forfeited	(752,000)	\$0.10		
Outstanding at September 30, 2006	1,850,000	\$0.30	8.8 years	\$557,000
Vested and Exercisable at September 30, 2006	171,000	\$0.12	5 years	\$20,000

The weighted average grant date fair value of stock options granted during the three and nine months ended September 30, 2006 was \$0.37, and during the three and nine months ended September 30, 2005 was \$0.07. As of September 30, 2006, the total unrecognized compensation expense related to nonvested stock option awards was \$244,000, which is expected to be recognized over a weighted average term of approximately 2.7 years. Total stock compensation expense recognized and the fair value of options vested for the three and nine months ended September 30, 2006 were not material.



**ACACIA RESEARCH CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**10. COMMITMENTS AND CONTINGENCIES**

*Collaborative and Research Agreements*

On February 8, 2006, the CombiMatrix group executed a one-year, \$2.1 million contract with the Department of Defense (“DoD”) to further the development of the CombiMatrix group's array technology for the electrochemical detection of biological and chemical threat agents. Under the terms of this contract, the CombiMatrix group will perform research and development activities, as described under the contract, and will be reimbursed on a periodic basis for actual costs incurred to perform its obligations, plus a fixed fee, of up to \$2.1 million. As of September 30, 2006, the CombiMatrix group had incurred \$1.1 million in actual contract costs for the electrochemical detection contract. In March 2004, the CombiMatrix group was awarded a two-year, \$5.9 million contract with the DoD to further the development of the CombiMatrix group's array technology for the detection of biological and chemical threat agents. This contract was completed in December 2005.

On August 9, 2006, the CombiMatrix group executed a two-year, \$1.9 million contract with the DoD, focusing on the integration of its electrochemical detection technology currently under development with the CombiMatrix group's microfluidics “lab-on-a-chip” technology to be used for military and homeland security applications. Under the terms of this contract, the CombiMatrix group will perform research and development activities, as described under the contract, and will be reimbursed on a periodic basis for actual costs incurred to perform its obligations, plus a fixed fee, of up to \$1.9 million. As of September 30, 2006, the CombiMatrix group had incurred \$61,000 in actual contract costs for the microfluidics contract.

In October 2004, the CombiMatrix group entered into an agreement to acquire up to a one-third ownership interest in Leuchemix, Inc. (“Leuchemix”), a private drug development firm, which is developing several compounds for the treatment of leukemia and other cancers. In accordance with the terms of the purchase agreement, the CombiMatrix group will purchase 3,137,500 shares of Series A Preferred Stock of Leuchemix for a total purchase price of \$4,000,000. The ownership interest will be acquired and paid for quarterly over the two-year period commencing with the fourth quarter of 2004. In accordance with the terms of the purchase agreement, the CombiMatrix group made an additional \$1,400,000 investment in Leuchemix during the nine months ended September 30, 2006, resulting in an ownership interest of approximately 29% as of September 30, 2006. The CombiMatrix group will make a final contractual investment in Leuchemix of \$750,000 in the fourth quarter of 2006 in accordance with the terms of the agreement. The CombiMatrix group's investment is being accounted for under the equity method.

*Litigation and Patent Enforcement*

Acacia Research Corporation is subject to claims, counterclaims and legal actions that arise in the ordinary course of business. Management believes that the ultimate liability with respect to these claims and legal actions, if any, will not have a material effect on our financial position, results of operations or cash flows. Companies comprising the Acacia Technologies group are often required to engage in litigation to enforce their patents and patent rights.

On September 30, 2002, CombiMatrix Corporation and Dr. Donald Montgomery entered into a settlement agreement with Nanogen, Inc. to settle all pending litigation between the parties. During the nine months ended September 30, 2005, the CombiMatrix group recorded a net non-cash credit totaling \$406,000 in connection with certain anti-dilution provisions of the settlement agreement. The related liability reflected management's estimate, as of each balance sheet date, of the fair value of AR-CombiMatrix stock potentially issuable to Nanogen, Inc. as a result of certain options and warrants exercised during the period, if any, and the fair value of AR-CombiMatrix stock potentially issuable to Nanogen, Inc. as of each balance sheet date pursuant to the anti-dilution terms of the agreement. The liability was

adjusted at each balance sheet date for changes in the market value of the AR-CombiMatrix stock and was reflected as long-term until settled in equity. The anti-dilution provisions of the settlement agreement expired in September 2005 and thus, there is no liability recorded as of September 30, 2005, or in any future periods, and there were no charges or credits recognized during the three and nine months ended September 30, 2006.

In addition to other terms of the settlement agreement, CombiMatrix Corporation is also required to make quarterly payments to Nanogen, Inc. equal to 12.5% of payments to CombiMatrix Corporation from sales of products developed by CombiMatrix Corporation and its affiliates and based on the patents that had been in dispute in the litigation, up to an annual maximum of \$1,500,000. The minimum quarterly payments under the settlement agreement are \$25,000 per quarter until the patents expire in 2018. Royalty expenses recognized under the agreement during the nine months ended September 30, 2006, and 2005, were \$338,000 and \$130,000, respectively.

**ACACIA RESEARCH CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

*Inventor Royalties and Contingent Legal Expenses*

In connection with the acquisition of certain patents and patent rights, certain companies included in the Acacia Technologies group executed related agreements which grant to the former owners of the respective patents or patent rights, the right to receive inventor royalties based on future net license fee revenues (as defined in the respective agreements) generated by the Acacia Technologies group as a result of licensing the respective patents or patent portfolios.

In connection with the Acacia Technologies group's licensing and enforcement activities, the Acacia Technologies group may retain the services of law firms that specialize in intellectual property licensing and enforcement and patent law. These law firms may be retained on a contingent fee basis in which the law firms are paid on a scaled percentage of any negotiated license fees, settlements or judgments awarded based on how and when the license fees, settlements or judgments are obtained by the Acacia Technologies group. In instances where the Acacia Technologies group does not recover license fees from potential infringers, no contingent legal fees are paid; however, the Acacia Technologies group is generally liable for certain out of pocket legal costs incurred pursuant to the underlying legal services agreement, which are expensed as incurred.

Inventor royalties and contingent legal fees paid are expensed in the consolidated statement of operations and comprehensive loss in the period that the related license fee revenues are recognized.

*Guarantees and Indemnifications*

Acacia Research Corporation has made guarantees and indemnities under which it may be required to make payments to a guaranteed or indemnified party, in relation to certain transactions, including revenue transactions in the ordinary course of business. In connection with certain facility leases Acacia Research Corporation has indemnified its lessors for certain claims arising from the facility or the lease. Acacia Research Corporation indemnifies its directors and officers to the maximum extent permitted under the laws of the State of Delaware. However, Acacia Research Corporation has a directors and officers insurance policy that may reduce its exposure in certain circumstances and may enable it to recover a portion of future amounts that may be payable, if any. The duration of the guarantees and indemnities varies and, in many cases is indefinite but subject to statute of limitations. The majority of guarantees and indemnities do not provide any limitations of the maximum potential future payments Acacia Research Corporation could be obligated to make. To date, we have made no payments related to these guarantees and indemnities. Acacia Research Corporation estimates the fair value of its indemnification obligations as insignificant based on this history and has therefore, not recorded any liability for these guarantees and indemnities in the accompanying consolidated balance sheets.

**11. DISCONTINUED OPERATIONS**

Results for the nine months ended September 30, 2005, include a \$210,000 charge, net of minority interests, related to estimated additional costs to be incurred in connection with the discontinued operations of Soundbreak.com (originally ceased operations in February 2001), related primarily to certain noncancellable lease obligations and a reduction in estimated amounts recoverable from existing sublease arrangements. The related lease obligations, which were guaranteed by Acacia Research Corporation, expired in August 2005. At September 30, 2006, assets consisted of cash and cash equivalents. At December 31, 2005, assets consisted of cash and cash equivalents and lease deposits. At September 30, 2006, liabilities related to miscellaneous accounts payable. At December 31, 2005, liabilities related primarily to miscellaneous payables and accrued lease termination costs. In April 2006, a final distribution to

Soundbreak.com's minority shareholders was paid totaling \$353,000. Refer to Note 13 for additional information on assets and liabilities related to discontinued operations for the periods presented.

## **12. SALE OF INTEREST IN SUBSIDIARY**

In January 2006, the CombiMatrix group expanded its relationship with one of its existing distributors, InBio, for the Asia Pacific region. Major components of the expanded relationship included the transfer of day-to-day operational responsibility and majority ownership of CombiMatrix K.K. to InBio, along with an expanded distribution agreement that encompasses Japan. InBio obtained 67% of the voting interests in CombiMatrix K.K. for a nominal amount of consideration. As a result, InBio assumed all operational and financial responsibilities of CombiMatrix K.K. The net loss on the sale of 67% of the voting interest in CombiMatrix K.K. recorded in the statement of operations in the first quarter of 2006 was \$84,000. CombiMatrix Corporation continues to own a 33% interest in CombiMatrix K.K. Subsequent to the sale, the CombiMatrix group's investment in CombiMatrix K.K. was accounted for under the equity method. The deconsolidation of CombiMatrix K.K. did not have a material impact on the consolidated balance sheets as of September 30, 2006.

**ACACIA RESEARCH CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**13. CONSOLIDATING SEGMENT INFORMATION**

Acacia Research Corporation has adopted the provisions of SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information." Our chief operating decision maker is considered to be Acacia Research Corporation's Chief Executive Officer ("CEO"). The CEO reviews and evaluates financial information presented on a group basis as described below. Management evaluates performance based on the profit or loss from continuing operations and financial position of its segments. Acacia Research Corporation has two reportable segments as described earlier in Note 1.

Material intercompany transactions and transfers have been eliminated in consolidation. The accounting policies of the segments are the same as those described in the summary of significant accounting policies.

Presented below is consolidating financial information for our reportable segments reflecting the businesses of the CombiMatrix group and the Acacia Technologies group. Earnings attributable to each group has been determined in accordance with accounting principles generally accepted in the United States.

**ACACIA RESEARCH CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**Consolidating Balance Sheets**  
(In thousands)  
(Unaudited)

	At September 30, 2006				At December 31, 2005			
	Acacia		CombiMatrix		Acacia		CombiMatrix	
	Group	Group Eliminations	Group	Group Eliminations	Group	Group Eliminations	Group	Group Eliminations
<b>ASSETS</b>								
Current assets:								
Cash and cash equivalents	\$ 25,487	\$ 2,304	\$ -	\$ 27,791	\$ 14,498	\$ 5,666	\$ -	\$ 20,164
Short-term investments	20,484	6,027	-	26,511	24,462	14,547	-	39,009
Accounts receivable	1,475	1,287	-	2,762	4,421	911	-	5,332
Prepaid expenses, inventory and other assets	1,333	622	-	1,955	1,406	709	-	2,115
Total current assets	48,779	10,240	-	59,019	44,787	21,833	-	66,620
Property and equipment, net of accumulated depreciation								
	189	2,070	-	2,259	121	2,363	-	2,484
Patents, net of accumulated amortization	19,827	7,104	-	26,931	23,786	7,926	-	31,712
Goodwill	121	16,918	-	17,039	121	18,859	-	18,980
Other assets	79	2,668	-	2,747	78	1,560	-	1,638
	\$ 68,995	\$ 39,000	\$ -	\$ 107,995	\$ 68,893	\$ 52,541	\$ -	\$ 121,434
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>								
Current liabilities:								
Accounts payable and accrued expenses	\$ 3,374	\$ 2,509	\$ -	\$ 5,883	\$ 1,441	\$ 2,483	\$ -	\$ 3,924
Royalties and legal fees payable	2,343	-	-	2,343	3,758	-	-	3,758
Current portion of deferred revenues	523	407	-	930	639	165	-	804
Total current liabilities	6,240	2,916	-	9,156	5,838	2,648	-	8,486
Deferred income taxes	-	-	-	-	726	1,975	-	2,701
Deferred revenues, net of current portion	-	1,145	-	1,145	-	1,439	-	1,439
Other liabilities	17	719	-	736	83	1,381	-	1,464
Total liabilities	6,257	4,780	-	11,037	6,647	7,443	-	14,090
Minority interests	-	-	-	-	443	4	-	447

Redeemable stockholders'  
equity:

AR - Acacia

Technologies stock	62,738	-	-	62,738	61,803	-	-	61,803
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AR - CombiMatrix stock	-	34,220	-	34,220	-	45,094	-	45,094
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Total stockholders' equity	62,738	34,220	-	96,958	61,803	45,094	-	106,897
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	\$ 68,995	\$ 39,000	\$ -	\$ 107,995	\$ 68,893	\$ 52,541	\$ -	\$ 121,434
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NOTE: Segment information for the Acacia Technologies group includes discontinued operations related to Soundbreak.com. Total assets related to discontinued operations totaled \$37,000 and \$741,000 at September 30, 2006, and December 31, 2005, respectively. Total liabilities related to discontinued operations totaled \$44,000 and \$144,000 at September 30, 2006, and December 31, 2005, respectively.

**ACACIA RESEARCH CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**Consolidating Statements of Operations****(In thousands)****(Unaudited)**

	For the Three Months Ended September 30, 2006			For the Nine Months Ended September 30, 2006		
	Acacia Technologies Group	CombiMatrix Group	Consolidated	Acacia Technologies Group	CombiMatrix Group	Consolidated
<b>Revenues:</b>						
Government contract	\$ -	\$ 725	\$ 725	\$ -	\$ 1,563	\$ 1,563
License fees	8,424	-	8,424	27,512	-	27,512
Products and service contracts	-	1,119	1,119	-	3,318	3,318
<b>Total revenues</b>	<b>8,424</b>	<b>1,844</b>	<b>10,268</b>	<b>27,512</b>	<b>4,881</b>	<b>32,393</b>
<b>Operating expenses:</b>						
Cost of government contract revenues	-	684	684	-	1,476	1,476
Cost of product sales	-	412	412	-	973	973
Research and development expenses (including non-cash stock compensation expense)	-	2,819	2,819	-	7,380	7,380
Marketing, general and administrative expenses (including non-cash stock compensation expense)	3,562	2,753	6,315	10,142	9,944	20,086
Legal expenses - patents	2,354	-	2,354	3,803	-	3,803
Inventor royalties and contingent legal fees expense - patents	2,623	-	2,623	12,741	-	12,741
Amortization of patents	1,322	274	1,596	3,991	822	4,813
Write-off of patent-related intangible asset	-	-	-	297	-	297
Loss from equity investments	-	253	253	-	786	786
<b>Total operating expenses</b>	<b>9,861</b>	<b>7,195</b>	<b>17,056</b>	<b>30,974</b>	<b>21,381</b>	<b>52,355</b>
<b>Operating loss</b>	<b>(1,437)</b>	<b>(5,351)</b>	<b>(6,788)</b>	<b>(3,462)</b>	<b>(16,500)</b>	<b>(19,962)</b>
<b>Other income (expense):</b>						
Interest and investment income	390	111	501	1,143	429	1,572
Loss on sale of interest in subsidiary	-	-	-	-	(84)	(84)
Warrant gains (charges)	-	913	913	-	663	663
	390	1,024	1,414	1,143	1,008	2,151



Total other income (expense)									
Loss from operations before income taxes	(1,047)	(4,327)	(5,374)	(2,319)	(15,492)	(17,811)			
(Provision) benefit for income taxes	(2)	-	(2)	(40)	34	(6)			
Net loss	\$ (1,049)	\$ (4,327)	\$ (5,376)	\$ (2,359)	\$ (15,458)	\$ (17,817)			

**ACACIA RESEARCH CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**Consolidating Statements of Operations****(In thousands)****(Unaudited)**

	<b>For the Three Months Ended</b>			<b>For the Nine Months Ended September 30, 2005</b>		
	<b>September 30, 2005</b>			<b>September 30, 2005</b>		
	<b>Acacia Technologies Group</b>	<b>CombiMatrix Group</b>	<b>Consolidated</b>	<b>Acacia Technologies Group</b>	<b>CombiMatrix Group</b>	<b>Consolidated</b>
<b>Revenues:</b>						
Government contract	\$ -	\$ 973	\$ 973	\$ -	\$ 2,985	\$ 2,985
License fees	6,783	-	6,783	11,328	-	11,328
Products and service contracts	-	490	490	-	1,404	1,404
<b>Total revenues</b>	<b>6,783</b>	<b>1,463</b>	<b>8,246</b>	<b>11,328</b>	<b>4,389</b>	<b>15,717</b>
<b>Operating expenses:</b>						
Cost of government contract revenues	-	920	920	-	2,820	2,820
Cost of product sales	-	282	282	-	635	635
Research and development expenses (including non-cash stock compensation expense)	-	1,527	1,527	-	4,082	4,082
Marketing, general and administrative expenses (including non-cash stock compensation expense)	2,113	2,805	4,918	5,482	7,475	12,957
Legal expenses - patents	1,076	-	1,076	2,173	-	2,173
Inventor royalties and contingent legal fees expense - patents	3,939	-	3,939	5,706	-	5,706
Inventor royalties - V-chip	225	-	225	225	-	225
Amortization of patents	1,334	273	1,607	3,586	821	4,407
Legal settlement credits	-	(211)	(211)	-	(406)	(406)
Loss from equity investments	-	100	100	-	202	202
<b>Total operating expenses</b>	<b>8,687</b>	<b>5,696</b>	<b>14,383</b>	<b>17,172</b>	<b>15,629</b>	<b>32,801</b>
<b>Operating loss</b>	<b>(1,904)</b>	<b>(4,233)</b>	<b>(6,137)</b>	<b>(5,844)</b>	<b>(11,240)</b>	<b>(17,084)</b>
<b>Other income:</b>						
Interest and investment income	312	122	434	762	328	1,090
Warrant gains (charges)	-	163	163	-	163	163
<b>Total other income</b>	<b>312</b>	<b>285</b>	<b>597</b>	<b>762</b>	<b>491</b>	<b>1,253</b>
	<b>(1,592)</b>	<b>(3,948)</b>	<b>(5,540)</b>	<b>(5,082)</b>	<b>(10,749)</b>	<b>(15,831)</b>

Loss from continuing operations before income taxes and minority interests						
Benefit for income taxes	33	65	98	99	133	232
Loss from continuing operations before minority interests	(1,559)	(3,883)	(5,442)	(4,983)	(10,616)	(15,599)
Minority interests	1	-	1	1	-	1
Loss from continuing operations	(1,558)	(3,883)	(5,441)	(4,982)	(10,616)	(15,598)
Discontinued operations:						
Estimated loss on disposal of discontinued operations	-	-	-	(210)	-	(210)
Net loss	\$ (1,558)	\$ (3,883)	\$ (5,441)	\$ (5,192)	\$ (10,616)	\$ (15,808)

**ACACIA RESEARCH CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**Consolidating Statements of Cash Flows**  
**(In thousands)**  
**(Unaudited)**

	For The Nine Months Ended September 30, 2006			For The Nine Months Ended September 30, 2005					
	Acacia Technology Group	Sombi Matrix Group	Eliminations	Consolidated	Acacia Technology Group	Sombi Matrix Group	Eliminations	Consolidated	
Cash flows from operating activities:									
Net loss	\$ (2,359)	\$ (15,458)	\$ -	\$ (17,817)	\$ (5,192)	\$ (10,616)	\$ -	\$ (15,808)	
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:									
Depreciation and amortization	4,046	1,507	-	5,553	3,629	1,631	-	5,260	
Minority interests	-	-	-	-	3	-	-	3	
Non-cash stock compensation	2,922	1,756	-	4,678	123	(146)	-	(23)	
Deferred income taxes	(36)	(34)	-	(70)	(107)	(103)	-	(210)	
Non-cash warrant charges (gains)	-	(663)	-	(663)	-	(163)	-	(163)	
Non-cash legal settlement charges (credits)	-	-	-	-	-	(406)	-	(406)	
Loss on disposal of discontinued operations	-	-	-	-	210	-	-	210	
Write-off of patent-related intangible asset	297	-	-	297	-	-	-	-	
Loss from equity investments	-	786	-	786	-	253	-	253	
Loss on sale of interest in subsidiary	-	84	-	84	-	-	-	-	
Stock issued to consultant	-	94	-	94	-	-	-	-	
Other	(82)	124	-	42	-	(128)	-	(128)	
Changes in assets and liabilities, excluding effect of business acquisition:									
Accounts receivable	2,946	(393)	-	2,553	(475)	(511)	-	(986)	
Prepaid expenses, inventory and other	(296)	83	-	(213)	(328)	(129)	(119)	(576)	

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assets

Accounts payable and accrued expenses	2,020	265	-	2,285	113	342	119	574
Royalties and legal fees payable	(1,415)	-	-	(1,415)	1,331	-	-	1,331
Deferred revenues	(116)	1	-	(115)	353	22	-	375

Net cash provided by (used in) operating activities from continuing operations	7,927	(11,848)	-	(3,921)	(340)	(9,954)	-	(10,294)
Net cash provided by (used in) operating activities from discontinued operations	222	-	-	222	(525)	-	-	(525)
Net cash provided by (used in) operating activities	8,149	(11,848)	-	(3,699)	(865)	(9,954)	-	(10,819)

Cash flows from investing activities:								
Purchase of property and equipment	(124)	(495)	-	(619)	(65)	(1,097)	-	(1,162)
Purchase of available-for-sale investments	(13,906)	(1,021)	-	(14,927)	(37,773)	(19,536)	-	(57,309)
Sale of available-for-sale investments	17,934	9,551	-	27,485	26,350	32,910	-	59,260
Business acquisition	(16)	-	-	(16)	(5,796)	-	-	(5,796)
Purchase of additional interests in equity method investee	-	(1,400)	-	(1,400)	-	(1,100)	-	(1,100)
Patent acquisition costs	(1,020)	-	-	(1,020)	(445)	-	-	(445)
Sale of interest in subsidiary (net of cash disposed)	-	(369)	-	(369)	-	-	-	-
Net cash provided by (used in) investing activities	2,868	6,266	-	9,134	(17,729)	11,177	-	(6,552)
Net cash used in investing activities from discontinued operations	(353)	-	-	(353)	-	-	-	-
Net cash provided by (used in) investing activities	2,515	6,266	-	8,781	(17,729)	11,177	-	(6,552)

Cash flows from financing activities:								
Net cash attributed to the Acacia Technologies group	325	-	-	325	19,572	-	-	19,572
Net cash attributed to the CombiMatrix group	-	2,220	-	2,220	-	12,969	-	12,969
Net cash provided by financing activities	325	2,220	-	2,545	19,572	12,969	-	32,541
Effect of exchange rate on cash								
	-	-	-	-	-	35	-	35
Increase (decrease) in cash and cash equivalents								
	10,989	(3,362)	-	7,627	978	14,227	-	15,205
Cash and cash equivalents, beginning								
	14,498	5,666	-	20,164	10,925	2,985	-	13,910
Cash and cash equivalents, ending								
	\$ 25,487	\$ 2,304	\$ -	\$ 27,791	\$ 11,903	\$ 17,212	\$ -	\$ 29,115

**ACACIA TECHNOLOGIES GROUP**  
**(A Division of Acacia Research Corporation)**  
**BALANCE SHEETS**  
**(In thousands)**  
**(Unaudited)**

<b>ASSETS</b>	<b>September 30, 2006</b>	<b>December 31, 2005</b>
<b>Current assets:</b>		
Cash and cash equivalents	\$ 25,487	\$ 14,498
Short-term investments	20,484	24,462
Accounts receivable	1,475	4,421
Prepaid expenses and other assets	1,333	1,406
<b>Total current assets</b>	<b>48,779</b>	<b>44,787</b>
Property and equipment, net of accumulated depreciation	189	121
Patents, net of accumulated amortization	19,827	23,786
Goodwill	121	121
Other assets	79	78
	<b>\$ 68,995</b>	<b>\$ 68,893</b>
<b>LIABILITIES AND ALLOCATED NET WORTH</b>		
<b>Current liabilities:</b>		
Accounts payable and accrued expenses	\$ 3,374	\$ 1,441
Royalties and legal fees payable	2,343	3,758
Current portion of deferred revenues	523	639
<b>Total current liabilities</b>	<b>6,240</b>	<b>5,838</b>
Deferred income taxes	-	726
Other liabilities	17	83
<b>Total liabilities</b>	<b>6,257</b>	<b>6,647</b>
Minority interests	-	443
Commitments and contingencies (Note 7)		
<b>Allocated net worth:</b>		
Funds allocated by Acacia Research Corporation	147,381	144,087
Accumulated net losses	(84,643)	(82,284)
<b>Total allocated net worth</b>	<b>62,738</b>	<b>61,803</b>
	<b>\$ 68,995</b>	<b>\$ 68,893</b>

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



**ACACIA TECHNOLOGIES GROUP**  
**(A Division of Acacia Research Corporation)**  
**STATEMENTS OF OPERATIONS**  
(In thousands)  
(Unaudited)

	<b>For the Three Months Ended</b>		<b>For the Nine Months Ended</b>	
	<b>September 30,</b>	<b>September 30,</b>	<b>September 30,</b>	<b>September 30,</b>
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
<b>Revenues:</b>				
License fees	\$ 8,424	\$ 6,783	\$ 27,512	\$ 11,328
<b>Operating expenses:</b>				
Marketing, general and administrative expenses (including non-cash stock compensation expense of \$985 and \$2,922 for the three and nine months ended September 30, 2006 and \$123 for the three and nine months ending September 30, 2005)	3,562	2,113	10,142	5,482
Legal expenses - patents	2,354	1,076	3,803	2,173
Inventor royalties and contingent legal fees expense - patents	2,623	3,939	12,741	5,706
Inventor royalties - V-chip	-	225	-	225
Amortization of patents	1,322	1,334	3,991	3,586
Write-off of patent-related intangible asset	-	-	297	-
<b>Total operating expenses</b>	<b>9,861</b>	<b>8,687</b>	<b>30,974</b>	<b>17,172</b>
<b>Operating loss</b>	<b>(1,437)</b>	<b>(1,904)</b>	<b>(3,462)</b>	<b>(5,844)</b>
<b>Other income:</b>				
Interest and investment income	390	312	1,143	762
<b>Loss from continuing operations before income taxes and minority interests</b>	<b>(1,047)</b>	<b>(1,592)</b>	<b>(2,319)</b>	<b>(5,082)</b>
(Provision) benefit for income taxes	(2)	33	(40)	99
<b>Loss from continuing operations before minority interests</b>	<b>(1,049)</b>	<b>(1,559)</b>	<b>(2,359)</b>	<b>(4,983)</b>
Minority interests	-	1	-	1
<b>Loss from continuing operations</b>	<b>(1,049)</b>	<b>(1,558)</b>	<b>(2,359)</b>	<b>(4,982)</b>
<b>Discontinued operations:</b>				
	-	-	-	(210)

Estimated loss on disposal of  
discontinued operations

Division net loss	\$	(1,049)	\$	(1,558)	\$	(2,359)	\$	(5,192)
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*The accompanying notes are an integral part of these financial statements.*

**ACACIA TECHNOLOGIES GROUP**  
**(A Division of Acacia Research Corporation)**  
**STATEMENTS OF CASH FLOWS**  
**(In thousands)**  
**(Unaudited)**

	<b>For the Nine Months Ended</b>	
	<b>September 30,</b>	<b>September 30,</b>
	<b>2006</b>	<b>2005</b>
<b>Cash flows from operating activities:</b>		
Division net loss	\$ (2,359)	\$ (5,192)
Adjustments to reconcile division net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	4,046	3,629
Minority interests	-	3
Non-cash stock compensation	2,922	123
Deferred income taxes	(36)	(107)
Loss on disposal of discontinued operations	-	210
Write-off of patent-related intangible asset	297	-
Other	(82)	-
Changes in assets and liabilities, excluding effect of business acquisitions:		
Accounts receivable	2,946	(475)
Prepaid expenses and other assets	(296)	(328)
Accounts payable and accrued expenses	2,020	113
Royalties and legal fees payable	(1,415)	1,331
Deferred revenues	(116)	353
Net cash provided by (used in) operating activities from continuing operations		
	7,927	(340)
Net cash provided by (used in) operating activities from discontinued operations		
	222	(525)
Net cash provided by (used in) operating activities		
	8,149	(865)
<b>Cash flows from investing activities:</b>		
Purchase of property and equipment	(124)	(65)
Purchase of available-for-sale investments	(13,906)	(37,773)
Sale of available-for-sale investments	17,934	26,350
Business acquisition (Note 6)	(16)	(5,796)
Patent acquisition costs	(1,020)	(445)
Net cash provided by (used in) investing activities		
	2,868	(17,729)
Net cash used in investing activities from discontinued operations		
	(353)	-
Net cash provided by (used in) investing activities		
	2,515	(17,729)
<b>Cash flows from financing activities:</b>		
Net cash flows attributed to the Acacia Technologies group	325	19,572
Increase in cash and cash equivalents		
	10,989	978

Cash and cash equivalents, beginning	14,498	10,925
Cash and cash equivalents, ending	\$ 25,487	\$ 11,903

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

**ACACIA TECHNOLOGIES GROUP**  
**(A Division of Acacia Research Corporation)**  
**NOTES TO FINANCIAL STATEMENTS (UNAUDITED)**

**1. DESCRIPTION OF BUSINESS AND BASIS OF PRESENTATION**

The Acacia Technologies group, a division of Acacia Research Corporation, develops, acquires, licenses and enforces patented technologies. The Acacia Technologies group owns and has rights to patent portfolios covering a wide range of technology areas. The Acacia Technologies group is primarily comprised of certain of Acacia Research Corporation's direct and or indirect wholly owned subsidiaries and limited liability companies including:

- Acacia Global Acquisition Corporation
- Acacia Media Technologies Corporation
- Acacia Patent Acquisition Corporation
- Acacia Technologies Services Corporation
- AV Technologies LLC
- Broadcast Data Retrieval Corporation
- Broadcast Innovation LLC
- Computer Acceleration Corporation
- Computer Cache Coherency Corporation
- Computer Docking Station Corporation
- Credit Card Fraud Control Corporation
- Data Encryption Corporation
- Data Innovation LLC
- Diagnostic Systems Corporation
- Disk Link Corporation
- Financial Systems Innovation LLC
- High Resolution Optics Corporation
- Information Technology Innovation LLC
- InternetAd LLC
- IP Innovation LLC
- KY Data Systems LLC
- Micromesh Technology Corporation
- Microprocessor Enhancement Corporation
- New Medium LLC
- Peer Communications Corporation
- Product Activation Corporation
- Resource Scheduling Corporation
- Software Collaboration Corporation
- Soundview Technologies, Inc.
- Spreadsheet Automation Corporation
- TechSearch LLC
- Telematics Corporation
- VData LLC

The Acacia Technologies group also includes all corporate assets, liabilities, and related transactions of Acacia Research Corporation attributed to Acacia Research Corporation's intellectual property licensing and enforcement business. Refer to "Business Acquisition" below for information on the Acacia Technologies group's 2005 business acquisition activity.

*Business Acquisition.* On January 28, 2005, Acacia Global Acquisition Corporation acquired the assets of Global Patent Holdings, LLC, which owned 11 patent licensing companies ("GPH Acquisition"). The acquisition provided the Acacia Technologies group ownership of companies that control 27 patent portfolios, which include 120 U.S. patents and certain foreign counterparts, and cover technologies used in a wide variety of industries. Refer to Note 6 for a description of the acquisition transaction.

*Liquidity and Risks.* Refer to Note 1 to the Acacia Research Corporation consolidated financial statements for a discussion of consolidated and individual group liquidity and risks.

*Basis of Presentation.* The unaudited interim Acacia Technologies group financial statements as of September 30, 2006, and for the interim periods presented, have been prepared in accordance with generally accepted accounting principles for interim financial information. These interim financial statements should be read in conjunction with the Acacia Technologies group financial statements and Acacia Research Corporation's consolidated financial statements and notes thereto for the year ended December 31, 2005. The year-end balance sheet data was derived from audited financial statements but does not include all disclosures required by accounting principles generally accepted in the

United States of America.

The Acacia Technologies group financial statements include all adjustments of a normal recurring nature which, in the opinion of management, are necessary for a fair statement of its financial position as of September 30, 2006, and the results of its operations and its cash flows for the interim periods presented. The results of operations for the three and nine months ended September 30, 2006, are not necessarily indicative of the results to be expected for the entire year.

28

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**ACACIA TECHNOLOGIES GROUP**  
**(A Division of Acacia Research Corporation)**  
**NOTES TO FINANCIAL STATEMENTS (UNAUDITED)**

*Capital Structure.* On December 11, 2002, our stockholders voted in favor of a recapitalization transaction, which became effective on December 13, 2002, whereby we created two new classes of common stock called Acacia Research-CombiMatrix common stock (“AR-CombiMatrix stock”) and Acacia Research-Acacia Technologies common stock (“AR-Acacia Technologies stock”), and divided our existing Acacia Research Corporation common stock into shares of the two new classes of common stock.

AR-Acacia Technologies stock is intended to reflect the separate performance of the Acacia Technologies group, a division of Acacia Research Corporation. The Acacia Technologies group is not a separate legal entity. Holders of AR-Acacia Technologies stock are stockholders of Acacia Research Corporation. As a result, holders of AR-Acacia Technologies stock are subject to all of the risks of an investment in Acacia Research Corporation and all of its businesses, assets and liabilities. The assets Acacia Research Corporation attributes to Acacia Technologies group could be subject to the liabilities of the CombiMatrix group.

The Acacia Technologies group financial statements taken together with the CombiMatrix group financial statements comprise all of the accounts included in the corresponding consolidated financial statements of Acacia Research Corporation. The financial statements of Acacia Technologies group reflect the financial position, results of operations, and cash flows of the businesses included therein. The financial statements of the Acacia Technologies group include the accounts or assets of Acacia Research Corporation specifically attributed to the Acacia Technologies group and were prepared using amounts included in Acacia Research Corporation’s consolidated financial statements.

Financial effects arising from one group that affect Acacia Research Corporation’s results of operations or financial condition could, if significant, affect the results of operations or financial condition of the other group and the market price of the class of common stock relating to the other group. Any division net losses of the CombiMatrix group or the Acacia Technologies group and dividends or distributions on, or repurchases of, AR-CombiMatrix stock or AR-Acacia Technologies stock or repurchases of preferred stock of Acacia Research Corporation will reduce the assets of Acacia Research Corporation legally available for payment of dividends on AR-CombiMatrix stock or AR-Acacia Technologies stock.

## **2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

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

*Revision in the Classification of Certain Securities.* In connection with the preparation of the 2005 consolidated financial statements, Acacia Research Corporation concluded that it was appropriate to classify its annuity investments as current investments. Prior to 2005, such investments had been classified as cash and cash equivalents. Accordingly, we have made adjustments to our consolidated statement of cash flows for the nine months ended September 30, 2005, to reflect the gross purchases of these securities as investing activities rather than as a component of cash and cash equivalents. This change in classification does not affect previously reported cash flows from operations or from financing activities in our previously reported statements of cash flows, and it does not affect our previously reported statements of operations for any period.

As of September 30, 2005, before this revision in classification, \$4,933,000 of these current investments were classified as cash and cash equivalents on our consolidated balance sheet. There were no material purchases or sales of annuity investments during any of the periods presented, as such, the impact of the revision in classification on consolidated cash flows from investing activities was not material for any of the periods presented.

*Concentrations.* Two and three licensee(s) individually accounted for greater than 10% of the Acacia Technologies group's license fee revenues recognized during the three and nine months ended September 30, 2006, as compared to one licensee during the three and nine months ended September 30, 2005, respectively. Three and two licensees represented approximately 82% and 95% of the Acacia Technologies group's accounts receivable at September 30, 2006 and December 31, 2005, respectively.



**ACACIA TECHNOLOGIES GROUP**  
**(A Division of Acacia Research Corporation)**  
**NOTES TO FINANCIAL STATEMENTS (UNAUDITED)**

*Stock-Based Compensation.* Refer to Note 2 and Note 9 to the Acacia Research Corporation consolidated financial statements included in Part I, Item 1 of this report.

*Earnings Per Share Information and Stock Option and Related Option Plan Information.* Earnings per share and stock option and related option plan information is omitted from the Acacia Technologies group footnotes because AR-Acacia Technologies stock is part of the capital structure of Acacia Research Corporation. The Acacia Technologies group is not a separate legal entity. Holders of AR-Acacia Technologies stock are stockholders of Acacia Research Corporation. This presentation reflects the fact that the Acacia Technologies group does not have legally issued common or preferred stock and AR-Acacia Technologies stock transactions are not legal transactions of the Acacia Technologies group. Refer to the Acacia Research Corporation consolidated financial statements for earnings per share information for Acacia Research Corporation's classes of stock, computed using the two-class method in accordance with SFAS No. 128, "Earnings per Share." Refer to the Acacia Research Corporation consolidated financial statements for disclosures regarding Acacia Research Corporation's stock option plans.

### **3. RECENT ACCOUNTING PRONOUNCEMENTS**

Refer to Note 5 to the Acacia Research Corporation consolidated financial statements included in Part I, Item 1 of this report.

### **4. GOODWILL AND INTANGIBLE ASSETS**

The Acacia Technologies group had \$121,000 of goodwill at September 30, 2006, and December 31, 2005. The Acacia Technologies group's identifiable intangible assets are comprised of patents and patent rights which have remaining economic useful lives up to 2013. The weighted average remaining economic useful life of the Acacia Technologies group's patents is approximately 5 years. Annual aggregate amortization expense for each of the five fiscal years through December 31, 2010 is estimated to be \$5,272,000 in 2006, \$5,235,000 in 2007, \$3,912,000 in 2008, \$3,461,000 in 2009 and \$3,270,000 in 2010. At September 30, 2006, and December 31, 2005, all of the Acacia Technologies group's acquired intangible assets other than goodwill were subject to amortization.

In June 2006, the Acacia Technologies group recorded a non-cash charge of \$297,000, related to the write-off of a patent-related intangible asset. We review long-lived assets and intangible assets for potential impairment when events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. In the event the sum of the expected undiscounted future cash flows resulting from the use of the asset is less than the carrying amount of the asset, an impairment loss equal to the excess of the asset's carrying value over its fair value is recorded. During the second quarter of 2006, pursuant to the terms of the respective license agreement, management elected to terminate its rights to exclusively license and enforce the patent, resulting in the write-off of the remaining carrying value of the patent-related intangible asset as of June 30, 2006.

For the nine months ended September 30, 2006, the Acacia Technologies group incurred patent acquisition costs totaling \$1,020,000 in connection with the acquisition of the rights to several additional patent portfolios. The acquired patents and patent rights have estimated economic useful lives ranging from 5 to 7 years. Refer to Note 6 for additions to patent related intangibles during the nine months ended September 30, 2005.

As of March 31, 2006, the Acacia Technologies group reduced its patents and deferred tax liability by \$691,000, which were initially recorded in fiscal 2002, to properly reflect the reduction in its income tax valuation allowance after consideration of the deferred tax liability.

## **5. EQUITY FINANCING**

In February 2005, Acacia Research Corporation raised gross proceeds of \$19,600,000 through the sale of 3,500,000 shares of AR-Acacia Technologies stock at a price of \$5.60 per share in a registered direct offering. Net proceeds raised of approximately \$19,532,000, which are net of related issuance costs, were attributed to the Acacia Technologies group. The shares of AR-Acacia Technologies stock were offered pursuant to an effective registration statement previously filed with the Securities and Exchange Commission.

**ACACIA TECHNOLOGIES GROUP**  
**(A Division of Acacia Research Corporation)**  
**NOTES TO FINANCIAL STATEMENTS (UNAUDITED)**

**6. ACQUISITION**

On January 28, 2005, Acacia Global Acquisition Corporation, a wholly owned subsidiary of Acacia Research Corporation, acquired substantially all of the assets of Global Patent Holdings, LLC, a privately held patent holding company based in Northbrook, Illinois, which owned 11 patent licensing companies. The acquisition provided the Acacia Technologies group 100% ownership of companies that control 27 patent portfolios, which include 120 U.S. patents and certain foreign counterparts, and cover technologies used in a wide variety of industries. As a result of the acquisition, we have expanded and diversified the Acacia Technologies group's potential revenue generating activities.

The acquisition was accounted for in accordance with the purchase method of accounting. Under the purchase method of accounting, the purchase consideration is allocated to the assets acquired, including tangible assets, patents and other identifiable intangibles and liabilities assumed, based on their estimated fair values at the date of acquisition. The consolidated statement of operations includes the results of the acquired companies beginning on January 28, 2005, the date of acquisition. The aggregate purchase consideration was approximately \$25,105,000, including \$5.0 million of cash, the issuance of 3,938,832 shares of AR-Acacia Technologies stock valued at \$19,293,000 (net of estimated common stock registration costs of \$228,000) and acquisition costs, including registration costs, of \$812,000. The value of the common shares issued was determined based on the average market price of AR-Acacia Technologies stock, as reported on NASDAQ, over the 5-day period (December 13 - December 17, 2004) before and after the terms of the acquisition were agreed to and announced.

The following table summarizes the total purchase consideration and the allocation of the consideration paid to the estimated fair value of the assets acquired and liabilities assumed (in thousands):

<b>Purchase Consideration:</b>	
Cash paid	\$ 5,000
Fair value of AR-Acacia Technologies stock issued <sup>(1)</sup>	19,293
Acquisition and registration costs	812
<b>Total purchase consideration</b>	<b>\$ 25,105</b>
 <b>Purchase Price Allocation:</b>	
Estimated fair value of net tangible assets acquired at January 28, 2005	\$ (26)
Intangible assets acquired - patents and patent rights <sup>(1)</sup>	25,131
<b>Total</b>	<b>\$ 25,105</b>

(1) Reflects non-cash investing activity.

Management was primarily responsible for determining the fair value of the tangible and identifiable intangible assets acquired and liabilities assumed at the date of acquisition. Management considered a number of factors in estimating the fair value of the intangible assets acquired, including reference to an independent valuation. The patents and patent rights acquired were valued using a discounted cash flow model on a patent portfolio by portfolio basis, which estimated the future net cash flows expected to result from the licensing of each portfolio, taking into account potential infringers of the patents, usage of the underlying technologies, estimated license fee revenues, contingent legal fee arrangements, royalties due to former patent holders, other estimated costs, tax implications and other factors. A discount rate consistent with the risks associated with achieving the estimated net cash flows was used to estimate the present value of future estimated net cash flows. Management's valuation resulted in an estimated fair value of patent related assets acquired of approximately \$27,000,000, resulting in approximately \$1,900,000 of excess

fair value over the cost of net assets acquired, which has been allocated as a pro rata reduction to the amounts that otherwise would have been assigned to the assets acquired, in accordance with the purchase method of accounting.

Amounts attributable to patents and patent rights acquired are amortized using the straight-line method over the estimated economic useful lives of the underlying patents which range from two to seven years. At the date of acquisition, the estimated weighted average useful life of amortizable patent related intangibles acquired was approximately 6 years.

**ACACIA TECHNOLOGIES GROUP**  
**(A Division of Acacia Research Corporation)**  
**NOTES TO FINANCIAL STATEMENTS (UNAUDITED)**

In connection with the acquisition described above, Acacia Global Acquisition Corporation entered into a consulting agreement with the former CEO of Global Patent Holdings, LLC who, as a result of the acquisition transaction, is also a shareholder of Acacia Research Corporation. The agreement requires the payment of \$2,000,000 in consulting fees over a two-year period, and certain reimbursable consulting related expenses, commencing on the date of acquisition. Marketing, general and administrative expenses for the three and nine months ended September 30, 2006 include \$272,000 and \$816,000, respectively, in expenses related to the consulting agreement. Marketing, general and administrative expenses for the three and nine months ended September 30, 2005 include \$274,000 and \$738,000, respectively, in expenses related to the consulting agreement.

The acquisition was treated for tax purposes as a taxable asset acquisition and, as such, Acacia Research Corporation did not record any book/tax basis differences and thus, no deferred income taxes were recorded in connection with the application of the purchase method of accounting.

## **7. COMMITMENTS AND CONTINGENCIES**

In connection with the acquisition of certain patents and patent rights, certain companies included in the Acacia Technologies group executed related agreements which grant to the former owners of the respective patents or patent rights, the right to receive royalties based on future net license fee revenues (as defined in the respective agreements) generated by the Acacia Technologies group as a result of licensing the respective patents or patent portfolios.

In connection with the Acacia Technologies group's licensing and enforcement activities, the Acacia Technologies group may retain the services of law firms that specialize in intellectual property licensing and enforcement and patent law. These law firms may be retained on a contingent fee basis in which the law firms are paid on a scaled percentage of any negotiated license fees, settlements or judgments awarded based on how and when the license fees, settlements or judgments are obtained by the Acacia Technologies group. In instances where the Acacia Technologies group does not recover license fees from potential infringers, no contingent legal fees are paid; however, the Acacia Technologies group is generally liable for certain out of pocket legal costs incurred pursuant to the underlying legal services agreement, which are expensed as incurred.

Royalties and contingent legal fees paid are expensed in the consolidated statement of operations in the period that the related license fee revenues are recognized.

The Acacia Technologies group is subject to claims, counterclaims and legal actions that arise in the ordinary course of business. Management believes that the ultimate liability with respect to these claims and legal actions, if any, will not have a material effect on the Acacia Technologies group's financial position, results of operations or cash flows. From time to time, companies comprising the Acacia Technologies group engage in litigation to enforce their patents and patent rights.

## **8. DISCONTINUED OPERATIONS**

Results for the nine months ended September 30, 2005, include a \$210,000 charge, net of minority interests, related to estimated additional costs to be incurred in connection with the discontinued operations of Soundbreak.com (originally ceased operations in February 2001), related primarily to certain noncancellable lease obligations and a reduction in estimated amounts recoverable from existing sublease arrangements. The related lease obligations, which

were guaranteed by Acacia Research Corporation, expired in August 2005. At September 30, 2006, assets consisted of cash and cash equivalents. At December 31, 2005, assets consisted of cash and cash equivalents and lease deposits. At September 30, 2006, liabilities related to miscellaneous accounts payable. At December 31, 2005, liabilities related primarily to miscellaneous payables and accrued lease termination costs. In April 2006, a final distribution to Soundbreak.com's minority shareholders was paid totaling \$353,000. Refer to Note 13 to the Acacia Research Corporation consolidated financial statements for additional information on assets and liabilities related to discontinued operations for the periods presented.

**COMBIMATRIX GROUP**  
**(A Division of Acacia Research Corporation)**  
**BALANCE SHEETS**  
**(In thousands)**  
**(Unaudited)**

	September 30, 2006	December 31, 2005
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 2,304	\$ 5,666
Available-for-sale investments	6,027	14,547
Accounts receivable	1,287	911
Inventory, prepaid expenses and other assets	622	709
<b>Total current assets</b>	<b>10,240</b>	<b>21,833</b>
Property and equipment, net of accumulated depreciation	2,070	2,363
Patents, net of accumulated amortization	7,104	7,926
Goodwill	16,918	18,859
Other assets	2,668	1,560
	\$ 39,000	\$ 52,541
<b>LIABILITIES AND ALLOCATED NET WORTH</b>		
Current liabilities:		
Accounts payable and accrued expenses	\$ 2,509	\$ 2,483
Current portion of deferred revenues	407	165
<b>Total current liabilities</b>	<b>2,916</b>	<b>2,648</b>
Deferred income taxes	-	1,975
Deferred revenues, net of current portion	1,145	1,439
Other liabilities	719	1,381
<b>Total liabilities</b>	<b>4,780</b>	<b>7,443</b>
Minority interests	-	4
Commitments and contingencies (Note 6)		
Allocated net worth:		
Funds allocated by Acacia Research Corporation	174,307	169,723
Accumulated net losses	(140,087)	(124,629)
<b>Total allocated net worth</b>	<b>34,220</b>	<b>45,094</b>

\$ 39,000 \$ 52,541

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



**COMBIMATRIX GROUP**  
**(A Division of Acacia Research Corporation)**  
**STATEMENTS OF OPERATIONS**  
(In thousands)  
(Unaudited)

	<b>For the Three Months Ended</b>		<b>For the Nine Months Ended</b>	
	<b>September 30,</b>	<b>September 30,</b>	<b>September 30,</b>	<b>September 30,</b>
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
<b>Revenues:</b>				
Government contract	\$ 725	\$ 973	\$ 1,563	\$ 2,985
Products	968	453	3,050	1,298
Service contracts	151	37	268	106
<b>Total revenues</b>	<b>1,844</b>	<b>1,463</b>	<b>4,881</b>	<b>4,389</b>
<b>Operating expenses:</b>				
Cost of government contract revenues	684	920	1,476	2,820
Cost of product sales	412	282	973	635
Research and development expenses (including non-cash stock compensation expense of \$311 and \$797 for the three and nine months ended September 30, 2006 and \$0 for the three and nine months ended September 30, 2005)	2,819	1,527	7,380	4,082
Marketing, general and administrative expenses (including non-cash stock compensation expense of \$277 and \$959 for the three and nine months ended September 30, 2006 and (\$35) and (\$146) for the three and nine months ended September 30, 2005)	2,753	2,805	9,944	7,475
Amortization of patents	274	273	822	821
Legal settlement credits	-	(211)	-	(406)
Loss from equity investments	253	100	786	202
<b>Total operating expenses</b>	<b>7,195</b>	<b>5,696</b>	<b>21,381</b>	<b>15,629</b>
<b>Operating loss</b>	<b>(5,351)</b>	<b>(4,233)</b>	<b>(16,500)</b>	<b>(11,240)</b>
<b>Other income (expense):</b>				
Interest and investment income	111	122	429	328
Loss on sale of interest in subsidiary	-	-	(84)	-
Warrant gains (charges)	913	163	663	163
<b>Total other income (expense)</b>	<b>1,024</b>	<b>285</b>	<b>1,008</b>	<b>491</b>
	<b>(4,327)</b>	<b>(3,948)</b>	<b>(15,492)</b>	<b>(10,749)</b>

Loss from operations before income  
taxes

Benefit for income taxes	-	65	34	133
Division net loss	\$ (4,327)	\$ (3,883)	\$ (15,458)	\$ (10,616)

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

**COMBIMATRIX GROUP**  
**(A Division of Acacia Research Corporation)**  
**STATEMENTS OF CASH FLOWS**  
**(In thousands)**  
**(Unaudited)**

	<b>For the Nine Months Ended</b>	
	<b>September 30,</b>	<b>September 30,</b>
	<b>2006</b>	<b>2005</b>
<b>Cash flows from operating activities:</b>		
Division net loss	\$ (15,458)	\$ (10,616)
<b>Adjustments to reconcile division net loss to net cash used in operating activities:</b>		
Depreciation and amortization	1,507	1,631
Non-cash stock compensation	1,756	(146)
Deferred income taxes	(34)	(103)
Non-cash warrant charges (gains)	(663)	(163)
Non-cash legal settlement charges (credits)	-	(406)
Loss from equity investments	786	253
Loss on sale of interest in subsidiary	84	-
Stock issued to consultant	94	-
Other	124	(128)
<b>Changes in assets and liabilities:</b>		
Accounts receivable	(393)	(511)
Inventory, prepaid expenses and other assets	83	(129)
Accounts payable and accrued expenses	265	342
Deferred revenues	1	22
<b>Net cash used in operating activities</b>	<b>(11,848)</b>	<b>(9,954)</b>
<b>Cash flows from investing activities:</b>		
Purchase of property and equipment	(495)	(1,097)
Purchase of available-for-sale investments	(1,021)	(19,536)
Sale of available-for-sale investments	9,551	32,910
Purchase of additional interests in equity method investee	(1,400)	(1,100)
Sale of interest in subsidiary (net of cash disposed)	(369)	-
<b>Net cash provided by investing activities</b>	<b>6,266</b>	<b>11,177</b>
<b>Cash flows from financing activities:</b>		
<b>Net cash flows attributed to the CombiMatrix group</b>	<b>2,220</b>	<b>12,969</b>
Effect of exchange rate on cash	-	35
<b>(Decrease) increase in cash and cash equivalents</b>	<b>(3,362)</b>	<b>14,227</b>
<b>Cash and cash equivalents, beginning</b>	<b>5,666</b>	<b>2,985</b>
<b>Cash and cash equivalents, ending</b>	<b>\$ 2,304</b>	<b>\$ 17,212</b>

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

**COMBIMATRIX GROUP**  
**(A Division of Acacia Research Corporation)**  
**NOTES TO FINANCIAL STATEMENTS (UNAUDITED)**

**1. DESCRIPTION OF BUSINESS AND BASIS OF PRESENTATION**

*Description of Business.* Acacia Research Corporation is comprised of two separate divisions: the CombiMatrix group and the Acacia Technologies group.

Our life sciences business, referred to as the “CombiMatrix group,” a division of Acacia Research Corporation, is comprised of our wholly owned subsidiary, CombiMatrix Corporation and CombiMatrix Corporation’s wholly owned subsidiary, CombiMatrix Molecular Diagnostics and includes all corporate assets, liabilities and transactions related to Acacia Research Corporation’s life sciences business.

The CombiMatrix group develops proprietary technologies and products and services in the areas of drug development, genetic analysis, nanotechnology research, defense and homeland security markets, and other markets where its products could be utilized. Among the technologies being developed by the CombiMatrix group is a platform technology to produce customizable arrays, which are semiconductor-based tools for use in identifying and determining the roles of genes, gene mutations and proteins. This technology has potential applications in the areas of genomics, proteomics, biosensors, drug discovery, drug development, diagnostics, combinatorial chemistry, material sciences and nanotechnology. Other technologies include proprietary molecular synthesis and screening methods for the discovery of potential new drugs. CombiMatrix Molecular Diagnostics, Inc., a wholly owned subsidiary located in Irvine, California, is exploring opportunities for the CombiMatrix group’s arrays in the field of molecular diagnostics. CombiMatrix K.K., a Japanese corporation located in Tokyo, Japan, has existed for the purpose of exploring opportunities for CombiMatrix Corporation’s array system with pharmaceutical and biotechnology companies in the Asian market. In January 2006, CombiMatrix Corporation sold 67% of its ownership interest in CombiMatrix K.K. to a third party. Refer to Note 7.

In January 2006, Acacia Research Corporation’s board of directors approved a plan for its wholly owned subsidiary, CombiMatrix Corporation, to become an independent public company. The transaction is expected to be completed no sooner than the first quarter of 2007, subject, however, to determination that there are no significant negative tax consequences to Acacia Research Corporation or its shareholders and completing the required filings with the Securities and Exchange Commission, or SEC. We have received a private letter ruling from the IRS addressing certain tax implications of the transaction and have requested a tax opinion from counsel. If the conditions are met, Acacia Research Corporation will redeem all of the issued and outstanding shares of AR-CombiMatrix common stock for all of the common stock of CombiMatrix Corporation, which will register its common stock under the Securities and Exchange Act of 1934. Following the redemption, CombiMatrix Corporation will apply to list its shares for trading on a national exchange.

*Liquidity and Risks.* Anticipated cash flows from operations and other sources may not be sufficient to meet the capital requirements of the CombiMatrix group beyond March 31, 2007 and as a result will be seeking additional sources of capital including the issuance of debt and/or equity securities. Refer to Note 1 to the Acacia Research Corporation consolidated financial statements for a detailed discussion of consolidated and individual group liquidity and risks.

*Basis of Presentation.* The unaudited interim CombiMatrix group financial statements as of September 30, 2006, and for the interim periods presented, have been prepared in accordance with generally accepted accounting principles for interim financial information. These interim financial statements should be read in conjunction with the CombiMatrix group financial statements and Acacia Research Corporation’s consolidated financial statements and notes thereto for the year ended December 31, 2005. The year-end balance sheet data was derived from audited financial statements but

does not include all disclosures required by accounting principles generally accepted in the United States of America.

The CombiMatrix group financial statements include all adjustments of a normal recurring nature which, in the opinion of management, are necessary for a fair statement of its financial position as of September 30, 2006, and the results of its operations and its cash flows for the interim periods presented. The results of operations for the three and nine months ended September 30, 2006, are not necessarily indicative of the results to be expected for the entire year.

**COMBIMATRIX GROUP**  
**(A Division of Acacia Research Corporation)**  
**NOTES TO FINANCIAL STATEMENTS (UNAUDITED)**

*Capital Structure.* On December 11, 2002, Acacia Research Corporation's stockholders voted in favor of a recapitalization transaction, which became effective on December 13, 2002, whereby Acacia Research Corporation created two new classes of common stock called Acacia Research-CombiMatrix common stock ("AR-CombiMatrix stock") and Acacia Research-Acacia Technologies common stock ("AR-Acacia Technologies stock"), and divided Acacia Research Corporation's existing Acacia Research Corporation common stock into shares of the two new classes of common stock.

AR-CombiMatrix stock is intended to reflect the separate performance of the CombiMatrix group, a division of Acacia Research Corporation. The CombiMatrix group is not a separate legal entity. Holders of AR-CombiMatrix stock are stockholders of Acacia Research Corporation. As a result, holders of AR-CombiMatrix stock are subject to all of the risks of an investment in Acacia Research Corporation and all of its businesses, assets and liabilities. The assets that Acacia Research Corporation attributes to the CombiMatrix group could be subject to the liabilities of the Acacia Technologies group.

The CombiMatrix group financial statements taken together with the Acacia Technologies group financial statements comprise all of the accounts included in the corresponding consolidated financial statements of Acacia Research Corporation. The financial statements of the CombiMatrix group reflect the financial position, results of operations, and cash flows of the businesses included therein. The financial statements of the CombiMatrix group include the accounts or assets of Acacia Research Corporation specifically attributed to the CombiMatrix group and were prepared using amounts included in Acacia Research Corporation's consolidated financial statements.

Financial effects arising from one group that affect Acacia Research Corporation's results of operations or financial condition could, if significant, affect the results of operations or financial condition of the other group and the market price of the class of common stock relating to the other group. Any division net losses of the CombiMatrix group or the Acacia Technologies group and dividends or distributions on, or repurchases of, AR-CombiMatrix stock or AR-Acacia Technologies stock or repurchases of preferred stock of Acacia Research Corporation will reduce the assets of Acacia Research Corporation legally available for payment of dividends on AR-CombiMatrix stock or AR-Acacia Technologies stock.

## **2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

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

*Concentrations.* Two and no customer(s) individually accounted for greater than 10% of the CombiMatrix group's product sales recognized during the three and nine months ended September 30, 2006, as compared to one and no customer(s) during the three and nine months ended September 30, 2005, respectively. Five and two customers represented approximately 89% and 84% of the CombiMatrix group's accounts receivable at September 30, 2006 and December 31, 2005, respectively.

*Stock-Based Compensation.* Refer to Note 2 and Note 9 to the Acacia Research Corporation consolidated financial statements included in Part I, Item 1 of this report.

*Earnings Per Share Information and Stock Option and Related Option Plan Information.* Earnings per share and stock option and related option plan information is omitted from the CombiMatrix group footnotes because AR-CombiMatrix stock is part of the capital structure of Acacia Research Corporation. The CombiMatrix group is not a separate legal entity. Holders of AR-CombiMatrix stock are stockholders of Acacia Research Corporation. This presentation reflects the fact that the CombiMatrix group does not have legally issued common or preferred stock and AR-CombiMatrix stock transactions are not legal transactions of the CombiMatrix group. Refer to the Acacia Research Corporation consolidated financial statements for earnings per share information for Acacia Research Corporation's classes of stock, computed using the two-class method in accordance with SFAS No. 128, "Earnings per Share." Refer to the Acacia Research Corporation consolidated financial statements for disclosures regarding Acacia Research Corporation's stock option plans.



**COMBIMATRIX GROUP**  
**(A Division of Acacia Research Corporation)**  
**NOTES TO FINANCIAL STATEMENTS (UNAUDITED)**

*Warrant Liability.* Refer to Note 8 to the Acacia Research Corporation consolidated financial statements included in Part I, Item 1 of this report.

### **3. RECENT ACCOUNTING PRONOUNCEMENTS**

Refer to Note 5 to the Acacia Research Corporation consolidated financial statements included in Part I, Item 1 of this report.

### **4. GOODWILL AND INTANGIBLE ASSETS**

The CombiMatrix group's identifiable intangible assets are patents, which have remaining economic useful lives up to 2020. Annual aggregate amortization expense for each of the five fiscal years through December 31, 2010 is estimated to be \$1,095,000 per year. At September 30, 2006 and December 31, 2005, all of the CombiMatrix group's acquired intangible assets other than goodwill were subject to amortization.

As of March 31, 2006, the CombiMatrix group reduced its goodwill and deferred tax liability balances by \$1,941,000, which were initially recorded in fiscal 2000, to properly reflect the reduction in its income tax valuation allowance after consideration of the deferred tax liability.

### **5. EQUITY FINANCING**

On June 14, 2006, Acacia Research Corporation entered into a standby equity distribution agreement (the "SEDA") with Cornell Capital Partners, LP ("Cornell"). Under the terms of the SEDA, Acacia Research Corporation can require Cornell to purchase up to \$50.0 million of AR-CombiMatrix common stock, or up to 13,024,924 shares, over a two-year period following the effective date of the SEDA. Such shares will be in the form of registered securities drawn from Acacia Research Corporation's current shelf registration statement and the proceeds from each advance will be contributed to the CombiMatrix group. Acacia Research Corporation can request advances under the SEDA in up to \$5.0 million increments. At the closing of each advance, which will take place six days after the initial notification to Cornell, Acacia Research Corporation will issue to Cornell a number of shares of AR-CombiMatrix common stock equal to the amount of the advance divided by the lowest daily volume weighted average price ("VWAP") of AR-CombiMatrix common stock during the five trading days following the advance notice to Cornell, which will purchase the shares at 97.5% of the VWAP. Management can also specify a floor price whereby shares that trade below this price during the five-day trading period will be excluded from determining the VWAP. At each closing, Acacia Research Corporation will pay an underwriting fee of 4% of the gross amount of each advance on the first \$20.0 million and 5% of the gross proceeds of each advance on the remaining \$30.0 million of the SEDA to Cornell. Acacia Research Corporation is not obligated to request any advances under the agreement and will not pay any additional fees to Cornell so long as no advances are requested. The SEDA is also cancelable by Acacia Research Corporation at any time, without penalty. Acacia Research Corporation may not request advances if the shares to be issued in connection with such advances would result in Cornell owning more than 9.9% of the outstanding AR-CombiMatrix common stock. A total of 13,024,924 shares of AR-CombiMatrix common stock are authorized to be issued under the SEDA.

Upon closing of the SEDA, the CombiMatrix group paid Cornell a one-time commitment fee of \$550,000 and an additional \$20,000 in due diligence and other closing-related costs. The \$550,000 fee was recorded as a long-term

asset and will be amortized against future advances as costs of equity issuances. On June 23 2006, Cornell purchased 343,750 shares of AR-CombiMatrix common stock at \$1.60 per share (which was not an advance under the SEDA), based on the fair value of AR-CombiMatrix stock on June 12, 2006. The shares of AR-CombiMatrix stock were offered pursuant to an effective registration statement previously filed with the Securities and Exchange Commission. Since executing the SEDA through September 30, 2006, Acacia Research Corporation has requested three advances from Cornell to purchase a total of 2,019,646 shares of AR-CombiMatrix stock at prices ranging from \$1.16 to \$1.13 per share, resulting in net proceeds of \$2,207,000 contributed to the CombiMatrix group. Subsequent to September 30, 2006 through November 2, 2006, an additional 1,191,699 shares of AR-CombiMatrix stock at prices ranging from \$0.98 to \$0.73 per share have been sold to Cornell, generating net proceeds of \$863,000 contributed to the CombiMatrix group. As of November 2, 2006, 9,813,579 shares of AR-CombiMatrix common stock are available under the SEDA.

**COMBIMATRIX GROUP**  
**(A Division of Acacia Research Corporation)**  
**NOTES TO FINANCIAL STATEMENTS (UNAUDITED)**

**6. COMMITMENTS AND CONTINGENCIES**

*Collaborative and Research Agreements*

On February 8, 2006, the CombiMatrix group executed a one-year, \$2.1 million contract with the Department of Defense (“DoD”) to further the development of the CombiMatrix group's array technology for the electrochemical detection of biological and chemical threat agents. Under the terms of this contract, the CombiMatrix group will perform research and development activities, as described under the contract, and will be reimbursed on a periodic basis for actual costs incurred to perform its obligations, plus a fixed fee, of up to \$2.1 million. As of September 30, 2006, the CombiMatrix group had incurred \$1.1 million in actual contract costs for the electrochemical detection contract. In March 2004, the CombiMatrix group was awarded a two-year, \$5.9 million contract with the DoD to further the development of the CombiMatrix group's array technology for the detection of biological and chemical threat agents. This contract was completed in December 2005.

On August 9, 2006, the CombiMatrix group executed a two-year, \$1.9 million contract with the DoD, focusing on the integration of its electrochemical detection technology currently under development with the CombiMatrix group's microfluidics “lab-on-a-chip” technology to be used for military and homeland security applications. Under the terms of this contract, the CombiMatrix group will perform research and development activities, as described under the contract, and will be reimbursed on a periodic basis for actual costs incurred to perform its obligations, plus a fixed fee, of up to \$1.9 million. As of September 30, 2006, the CombiMatrix group had incurred \$61,000 in actual contract costs for the microfluidics contract.

In October 2004, the CombiMatrix group entered into an agreement to acquire up to a one-third ownership interest in Leuchemix, Inc. (“Leuchemix”), a private drug development firm, which is developing several compounds for the treatment of leukemia and other cancers. In accordance with the terms of the purchase agreement, the CombiMatrix group will purchase 3,137,500 shares of Series A Preferred Stock of Leuchemix for a total purchase price of \$4,000,000. The ownership interest will be acquired and paid for quarterly over the two-year period commencing with the fourth quarter of 2004. In accordance with the terms of the purchase agreement, the CombiMatrix group made an additional \$1,400,000 investment in Leuchemix during the nine months ended September 30, 2006, resulting in an ownership interest of approximately 29% as of September 30, 2006. The CombiMatrix group will make a final contractual investment in Leuchemix of \$750,000 in the fourth quarter of 2006 in accordance with the terms of the agreement. The CombiMatrix group's investment is being accounted for under the equity method.

*Litigation*

On September 30, 2002, CombiMatrix Corporation and Dr. Donald Montgomery entered into a settlement agreement with Nanogen, Inc. to settle all pending litigation between the parties. During the nine months ended September 30, 2005, the CombiMatrix group recorded a net non-cash credit totaling \$406,000 in connection with certain anti-dilution provisions of the settlement agreement. The related liability reflected management's estimate, as of each balance sheet date, of the fair value of AR-CombiMatrix stock potentially issuable to Nanogen, Inc. as a result of certain options and warrants exercised during the period, if any, and the fair value of AR-CombiMatrix stock potentially issuable to Nanogen, Inc. as of each balance sheet date pursuant to the anti-dilution terms of the agreement. The liability was adjusted at each balance sheet date for changes in the market value of the AR-CombiMatrix stock and is reflected as long-term until settled in equity. The anti-dilution provisions of the settlement agreement expired in September 2005 and thus, there is no liability recorded as of September 30, 2005, or in any future periods, and there were no charges or credits recognized during the three and nine months ending September 30, 2006.



**COMBIMATRIX GROUP**  
**(A Division of Acacia Research Corporation)**  
**NOTES TO FINANCIAL STATEMENTS (UNAUDITED)**

In addition to other terms of the settlement agreement, CombiMatrix Corporation is also required to make quarterly payments to Nanogen, Inc. equal to 12.5% of payments to CombiMatrix Corporation from sales of products developed by CombiMatrix Corporation and its affiliates and based on the patents that had been in dispute in the litigation, up to an annual maximum of \$1,500,000. The minimum quarterly payments under the settlement agreement are \$25,000 per quarter until the patents expire in 2018. Royalties recognized under the agreement during the nine months ended September 30, 2006, and 2005, were \$338,000 and \$130,000, respectively.

The CombiMatrix group is subject to claims and legal actions that arise in the ordinary course of business. Management believes that the ultimate liability with respect to these claims and legal actions, if any, will not have a material effect on the CombiMatrix group's financial position, results of operations or cash flows.

## **7. SALE OF INTEREST IN SUBSIDIARY**

In January 2006, the CombiMatrix group expanded its relationship with one of its existing distributors, InBio, for the Asia Pacific region. Major components of the expanded relationship included the transfer of day-to-day operational responsibility and majority ownership of CombiMatrix K.K. to InBio, along with an expanded distribution agreement that encompasses Japan. InBio obtained 67% of the voting interests in CombiMatrix K.K. for a nominal amount of consideration. As a result, InBio assumed all operational and financial responsibilities of CombiMatrix K.K. The net loss on the sale of 67% of the voting interest in CombiMatrix K.K. recorded in the statement of operations during the first quarter of 2006 was \$84,000. CombiMatrix Corporation continues to own a 33% interest in CombiMatrix K.K. Subsequent to the sale, the CombiMatrix group's investment in CombiMatrix K.K. was accounted for under the equity method. The deconsolidation of CombiMatrix K.K. did not have a material impact on the CombiMatrix group balance sheet as of September 30, 2006.

## **Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

### **Cautionary Statement**

You should read the following discussion and analysis in conjunction with the consolidated financial statements and related notes thereto contained in Part I, Item 1 of this report. The information contained in this Quarterly Report on Form 10-Q is not a complete description of our businesses or the risks associated with an investment in our common stock. We urge you to carefully review and consider the various disclosures made by us in this report and in our other reports filed with the Securities and Exchange Commission, or SEC, including our Annual Report on Form 10-K for the year ended December 31, 2005, filed with the SEC on March 16, 2006, and our Registration Statement on Form S-3 filed with the SEC on April 25, 2006, that discuss our businesses in greater detail.

This report contains forward-looking statements within the meaning of the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. Reference is made in particular to the description of our plans and objectives for future operations, assumptions underlying such plans and objectives, and other forward-looking statements included in this report. Such statements may be identified by the use of forward-looking terminology such as "may," "will," "expect," "believe," "estimate," "anticipate," "intend," "continue," or similar terms, variations of such terms negative of such terms. Such statements are based on management's current expectations and are subject to a number of factors and uncertainties, which could cause actual results to differ materially from those described in the forward-looking statements. Such statements address future events and conditions concerning, among others, product development, capital expenditures, earnings, litigation, regulatory matters, markets for products and services, liquidity and capital resources and accounting matters. Actual results in each case could differ materially from those anticipated in such statements by reason of factors such as future economic conditions, changes in consumer demand, legislative, regulatory and competitive developments in markets in which we and our subsidiaries operate, results of litigation and other circumstances affecting anticipated revenues and costs. We expressly disclaim any obligation or undertaking to release publicly any updates or revisions to any forward-looking statements contained herein to reflect any change in our expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based. Additional factors that could cause such results to differ materially from those described in the forward-looking statements are set forth in connection with the forward-looking statements and in our "Risk Factors" incorporated by reference in Part II, Item 1A of this report.

### **Businesses**

As used in this Form 10-Q, "we," "us" and "our" refer to Acacia Research Corporation and its subsidiary companies.

Acacia Research Corporation, a Delaware corporation, was originally incorporated in California in January 1993 and reincorporated in Delaware in December 1999.

The following discussion is based primarily on our unaudited consolidated balance sheet as of September 30, 2006, and on our unaudited consolidated statement of operations for the period from January 1, 2006, to September 30, 2006. The discussion compares the activities for the three and nine months ended September 30, 2006, to the activities for the three and nine months ended September 30, 2005. This information should be read in conjunction with the accompanying unaudited consolidated financial statements and notes thereto. This information should also be read in conjunction with the "Risk Factors" incorporated by reference in Part II, Item 1A of this report.

Acacia Research Corporation is comprised of two operating groups, the CombiMatrix group, our life sciences business, and the Acacia Technologies group, our intellectual property licensing and enforcement business.

The Acacia Technologies group, a division of Acacia Research Corporation, develops, acquires, licenses and enforces patented technologies. The Acacia Technologies group currently controls 52 patent portfolios covering technologies used in a wide variety of industries.

The CombiMatrix group, a division of Acacia Research Corporation, develops proprietary technologies and products and services in the areas of drug development, genetic analysis, nanotechnology research, defense and homeland security markets, and other markets where its products could be utilized. Among the technologies being developed by the CombiMatrix group is a platform technology to produce customizable arrays, which are semiconductor-based tools for use in identifying and determining the roles of genes, gene mutations and proteins. This technology has potential applications in the areas of genomics, proteomics, biosensors, drug discovery, drug development, diagnostics, combinatorial chemistry, material sciences and nanotechnology. Other technologies include proprietary molecular synthesis and screening methods for the discovery of potential new drugs. CombiMatrix Molecular Diagnostics, Inc., (“CMDX”), a wholly owned subsidiary located in Irvine, California, is exploring opportunities for the CombiMatrix group’s arrays in the field of molecular diagnostics.

Refer to Note 1 to the Acacia Research Corporation consolidated financial statements included in Part I, Item 1 of this report, for a description of Acacia Research Corporation’s operating groups.

## Overview

### *Acacia Technologies Group*

The Acacia Technologies group's operating activities for the three and nine months ended September 30, 2006, were principally focused on the continued development, licensing and enforcement of its patent portfolios, including the continued pursuit of multiple ongoing technology licensing programs and the commencement of new technology licensing programs. In addition, we continued our focus on business development, including the acquisition of additional patent portfolios and the continued pursuit of opportunities to partner with patent owners and provide Acacia Technologies group's unique intellectual property licensing, development and enforcement services.

Revenues for the three and nine months ended September 30, 2006 were \$8.4 million and \$27.5 million, respectively, representing increases of approximately 24% and 143% over the respective comparable 2005 periods. Trailing twelve-month revenues as of September 30, 2006 were \$35.8 million, compared to \$34.1 million as of June 30, 2006, \$19.6 million as of December 31, 2005 and \$12.1 million as of September 30, 2005.

Revenues for the nine months ended September 30, 2006 included license fees from 58 new licensing agreements covering 12 of our technology licensing programs, as compared to 61 new licensing agreements covering 11 of our technology licensing programs in the comparable 2005 periods. The Acacia Technologies group generated licensing revenues from 5 new technology licensing programs during the nine months ended September 30, 2006, and to date, the Acacia Technologies group has generated revenues from 18 of its technology licensing programs. License fee revenues for the three and nine months ended September 30, 2006 included fees from the licensing of our DMT® technology, Audio/Video Enhancement and Synchronization technology and Image Resolution technology, Interstitial Internet Advertising technology, Laptop Connectivity technology, Multi-Dimensional Bar Code technology, Resource Scheduling technology, Dynamic Manufacturing Modeling technology, Product Activation technology, Enhanced Internet Navigation technology, Interactive Data Sharing technology, and Credit Card Fraud Protection technology.

Marketing, general and administrative expenses increased during the three and nine months ended September 30, 2006, as compared to the same periods in 2005, due primarily to the hiring of additional patent licensing, business development and engineering personnel since September 30, 2005 and an increase in corporate, general and administrative costs related to the Acacia Technologies group's ongoing operations. Despite the increase in licensing revenues, inventor royalties expenses and contingent legal fees expenses decreased for the three months ended September 30, 2006, as compared to the same period in 2005, due to the mix of patent portfolios generating revenue for the respective periods and the related economic terms of the underlying inventor and contingent fee arrangements, if any, associated with the revenue generating patent portfolios for the respective periods, as discussed below. Inventor royalties expenses and contingent legal fees expenses increased for the nine months ended September 30, 2006, as compared to the same period in 2005, due to the overall increase in related license fee revenues.

During the nine months ended September 30, 2006, the Acacia Technologies group continued to execute its business strategy in the area of patent portfolio acquisitions, including the acquisition of, or the acquisition of the rights to, the following patent portfolios:

- *Video Tracking Technology Patent.* Acquired rights to a patent relating to improving the performance and user experience of video conferencing technologies. The patent generally relates to technology for automatically tracking and centering the images of videoconference participants. This technology allows webcams and other digital cameras to automatically optimize and align a videoconference participant's image in each of the other conference participants' displays. The Video Tracking technology improves desktop videoconferencing and video mail performance.



*Portable Audio Device Patent.* Acquired a patent relating to portable audio recording and playback devices from ESPRO Information Technologies, Ltd., [www.espro.com](http://www.espro.com), a provider of electronic audio guiding and interpretation systems. The patented technology relates to products such as certain MP3 players and cell phones using solid state memory that can download compressed audio and record analog audio.

- *Software License Management Patent.* Acquired rights to a patent relating to software license management technology. The patent generally relates to technology for monitoring and tracking the use of software applications across a network. This technology can be used to provide a system for managing software license compliance in an enterprise environment as well as metering actual usage levels in a Software-as-a-Service (“SaaS”) environment.
- *Telematics Technology Patents.* Acquired patents relating to the rapidly growing field of telematics. Telematics refers to systems used in vehicles that combine wireless communication with GPS tracking and can be used in vehicle navigation systems and mobile fleet management. The patents generally relate to technology for displaying mobile vehicle information on a map. This technology can be used in navigation and fleet management systems that combine wireless communication with GPS tracking and map displays.
- *File Locking in Shared Storage Network Patent.* Acquired rights to a patent relating to a file locking system for use in shared storage networks such as iSCSI. The use of the patented technology removes a single point of failure for companies migrating existing Storage Area Network (“SAN”) implementations to iSCSI or for those creating new shared storage networks.
- *Remote Video Camera Patents.* Acquired patents relating to remote control of video cameras and other devices used in areas such as videoconferencing and surveillance systems. The uses of the patented technology include improved remote management of video camera functions such as pan, tilt, and focus, and improved device control in a networked videoconferencing system.
- *Audio Communications Fraud Detection Patents.* Acquired rights to patents relating to the detection of fraud in connection with paid communication services, such as audio communications. The patented technology generally relates to a process for detecting, reducing and preventing fraud in connection with payments for certain communication services, including audio sessions delivered via the telephone, Internet, and other communication networks.
- *Micromirror Digital Display Patents.* Acquired a patent portfolio relating to the use of micromirrors to create a digital image in televisions, monitors, and projectors. The patented technology generally relates to techniques for using micromirrors to display a color image having gray scale gradations and is utilized in large screen televisions and projectors.
- *Fluid Flow Control and Monitoring Patent.* Acquired rights to patent relating to systems used in the remote control and monitoring of fluid flow, both gas and liquid. This technology can be used in heating/ventilation/air conditioning (“HVAC”), plumbing and other industrial, commercial and residential fluid flow systems.
- *Medical Images Stabilization Patents.* This patented technology can be used in stabilizing medical images for interventional procedures such as cardiac catheters and stents, and for diagnostics procedures such as visualization of arterial lesions.
- *Vehicle Magnetic Braking and Motor Technology Patents.* These patents generally relate to technology for smooth, reliable braking and acceleration of vehicles on parallel rails.
- *Web Personalization Patents.* This patented technology generally relates to technology for learning user preferences and automatically personalizing a user's online experience. The technology is applicable to web sites that use categories plus attributes to identify items, and where individual attributes apply to multiple categories.

*2005 Acquisition.* On January 28, 2005, Acacia Global Acquisition Corporation, a wholly owned subsidiary of Acacia Research Corporation, acquired substantially all of the assets of Global Patent Holdings, LLC, a privately held patent

holding company based in Northbrook, Illinois, which owned 11 patent licensing companies (“GPH Acquisition”). The acquisition provided the Acacia Technologies group 100% ownership of companies that control 27 patent portfolios, which include 120 U.S. patents and certain foreign counterparts, and cover technologies used in a wide variety of industries, as set forth below. The GPH Acquisition, and other patent acquisitions during 2005 and 2006, continue to expand and diversify the Acacia Technologies group’s revenue generating opportunities and furthers the execution of the Acacia Technologies group’s business strategy of acquiring, developing and licensing patented technologies.

*CombiMatrix Group*

During the three and nine months ended September 30, 2006, the CombiMatrix group's operating activities included the recognition of \$1.8 million and \$4.9 million in revenues, including \$725,000 and \$1.6 million in government contract revenues, and \$1.1 million and \$3.3 million in CustomArrays™ product, equipment and service revenues, including \$153,000 and \$221,000 of array revenue from our wholly owned diagnostics subsidiary, CombiMatrix Molecular Diagnostics, or CMDX. CustomArray product and service revenues increased 128% from the third quarter of 2005 and decreased 8% from the prior three months ending June 30, 2006. While the CombiMatrix group has achieved significant growth in its product and service revenues from the prior year, a decrease in the number of instruments sold in the third quarter of 2006 compared to the second quarter resulted in the slight overall decrease in revenues from the previous quarter. This was partially offset by an increase in CustomArray microarrays and related hardware, including \$153,000 in array revenues recognized by CMDX in the third quarter of 2006 compared to \$71,000 in the second quarter of 2006. Research and development expenses, excluding government contract costs, increased due primarily to the impact of CMDX, which was formed and began research and development activities in the second quarter of 2005.

During the third quarter of 2006, the CombiMatrix group made significant developments in a number of its strategic business objectives including its commercial array technology platform, its partnership with the U.S. government and in the area of clinical diagnostics.

Regarding its array platform, the CombiMatrix group executed one manufacturing and distribution agreement and two non-exclusive array access agreements under its Combi-Core™ access program, increasing its global network of distributors for CustomArray products. The CombiMatrix group also launched, in collaboration with Furuno Electric Co., Ltd., its QuadroCAS™ CustomArray synthesizer and made available new versions of its Influenza A and miRNA product offerings.

In the area of national defense, the CombiMatrix group executed a new two-year, \$1.9 million contract with the US Department of Defense, or DoD, for the purposes of integrating its electrochemical detection technology with its microfluidics "lab-on-a-chip" technology for national defense and homeland security applications.

In the area of clinical diagnostics, CMDX received a letter from the Office of In Vitro Diagnostic Device Evaluation and Safety ("OIVD") of the US Food and Drug Administration ("FDA"). The letter invited CMDX to meet with the OIVD to discuss CMDX's plans to market its Constitutional Genetic Array Test ("CGAT"). After meeting with the FDA in September 2006, CMDX received a second letter from the OIVD indicating that the FDA agreed with management that CMDX's CGAT does not require regulation covered by recent FDA guidelines covering certain diagnostic assays. CMDX also launched its first molecular diagnostic service using its CGAT platform.

Historically, the CombiMatrix group has relied upon investing and financing activities to fund operating activities. Net proceeds to the CombiMatrix group from investing and financing activities were considerably lower for the nine months ended September 30, 2006, than for the nine months ended September 30, 2005, and its cash and cash equivalent balances, anticipated cash flows from operations and other existing sources of credit may not be sufficient to meet the capital requirements beyond March 31, 2007. The CombiMatrix group will be seeking additional sources of capital including the issuance of debt and/or equity securities.

## **Patent Enforcement Litigation**

Companies comprising the Acacia Technologies group are often required to engage in litigation to enforce their patents and patent rights. In the litigation listed below, certain companies comprising the Acacia Technologies group are parties to ongoing litigation alleging infringement of certain of our patented technologies by the companies listed. Current patent enforcement litigation, by related patented technology, is as follows:

### ***Audio/Video Enhancement and Synchronization Technology***

#### ***Image Resolution Enhancement Technology***

- IP Innovation, LLC and Technology Licensing Corporation v. Lexmark International, Inc. United States District Court for the Northern District of Illinois. Filed 10/23/02. Case No. 1:02-cv-07611.
- IP Innovation, LLC and Technology Licensing Corporation v. Dell Computer Corporation. United States District Court for the Northern District of Illinois. Filed 5/15/03. Case No. 1:03-cv-03245.
- New Medium Technologies, LLC and AV Technologies, LLC v. Barco NV, Miranda Technologies, LG Philips LCD, Toshiba Corporation, Toshiba America Consumer Products, LLC, LG Electronics, Inc., and Syntax-Brilliant Corporation. United States District Court for the Northern District of Illinois. Filed 9/29/05. Case No. 1:05-cv-05620.

### ***Broadcast Data Retrieval Technology***

- Broadcast Data Retrieval Corporation v. Sirius Satellite Radio, Inc. Transferred to United States District Court for the Southern District of New York 7/6/06. Case No. 1:06-cv-05135.

### ***Laptop Connectivity Technology***

- Computer Docking Station Corporation v. Dell, Inc., Gateway, Inc., Toshiba America, Inc., and Toshiba America Information Systems, Inc.. United States District Court for the Western District of Wisconsin. Filed 1/17/06. Case No. 06-c-0032-c.

### ***Computer Memory Cache Coherency Technology***

- Computer Cache Coherency Corporation v. VIA Technologies, Inc., Via Technologies, Inc. (USA) and Intel Corporation. United States District Court for the Northern District of California. Filed 12/2/04. Case No. 5:05-cv-01668.

### ***Credit Card Fraud Control Technology***

- Ingenio Inc. v. Acacia Patent Acquisition Corporation and Acacia Research Corporation. United States District Court for the Northern District of California. Filed 10/13/06. Case No. 3:06-cv-06423.

### ***Credit Card Fraud Protection Technology***

- Financial Systems Innovation, LLC and Paul N. Ware v. Gap, Inc., Racetrac Petroleum, Inc. and The Kroger Company. United States District Court for the Northern District of Georgia. Filed 3/3/04. Case No. 4:04-cv-00065.
- Financial Systems Innovation, LLC and Paul N. Ware v. Williams-Sonoma, Inc., Linens N Things, Inc. and Costco Wholesale Corporation. United States District Court for the Northern District of Texas. Filed 6/30/04. Case No. 4:04-cv-00479.
- Financial Systems Innovation, LLC and Paul N. Ware v. Circuit City Stores, Inc., Officemax Inc., Staples, Inc., Cracker Barrel Old Country Store, Inc., Fry's Electronics, Inc., and Rite Aid Corporation. United States District Court for the Northern District of Georgia. Filed 7/19/05. Case No. 4:05-cv-00156.
- Reinalt-Thomas Corporation, dba Discount Tire Corporation, v. Acacia Research Corporation, Paul N. Ware and Financial Systems Innovation, LLC. United States District Court for the District of Arizona. Filed 10/27/05. Case No. 2:05-cv-03459.
- Financial Systems Innovation, LLC and Paul Ware v. Discount Tire Company of Georgia, Inc. and Reinalt-Thomas Corporation, dba Discount Tire Company. United States District Court for the Northern District of Georgia. Filed

11/21/05. Case No. 4:05-cv-00252.

·Lone Star Steakhouse and Saloon, Inc. v. Acacia Technologies group and Financial Systems Innovation, LLC.  
United States District Court for the District of Kansas. Filed 8/5/05. Case No. 6:05-cv-01249.

***Computing Device Performance Technology***

·Computer Acceleration Corporation v. Microsoft Corporation. United States District Court for the East District of Texas. Filed 7/6/06. Case No. 9:06-cv-0140.

45

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***Data Encryption Technology***

·Data Encryption Corporation v. Microsoft Corporation and Dell Computer Corporation. United States District Court for the Central District of California. On appeal to the U.S. Court of Appeals for the Federal Court. Lower Court Case No. 2:05-cv-05531.

***Digital Media Transmission Technology***

·In accordance with the Transfer Order issued February 24, 2005, by the Judicial Panel on Multidistrict Litigation, all of the following Digital Media Transmission Technology cases have been transferred to the Northern District of California. The lead case number is 5:05-cv-01114.

·Acacia Media Technologies Corporation v. Comcast Cable Communications, LLC, Charter Communications, Inc., The DirectTV Group, Inc., Echostar Communications Corporation, Cox Communications, Inc., Hospitality Network, Inc. (a wholly owned subsidiary of Cox that supplies hotel on-demand TV services), Mediacom, LLC, Armstrong Group, Arvig Communication Systems, Block Communications, Inc., Cable America Corporation, Cable One, Inc., Cannon Valley Communications, Inc., East Cleveland Cable TV and Communications, LLC, Loretel Cablevision, Massillon Cable TV, Inc., Mid-Continent Media, Inc., NPG Cable, Inc., Savage Communications, Inc., Sjoberg's Cablevision, Inc., US Cable Holdings LP, and Wide Open West, LLC, Time Warner Cable, Cablevision Systems Corporation, Insight Communications Company, Cebridge Communications and Bresnan Communications.

·Acacia Media Technologies Corporation v. New Destiny Internet Group, Inc., Audio Communications Inc., VS Media Inc., Ademia Multimedia, LLC, International Web Innovations, Inc., Offendale Commercial BV, Ltd., Adult Entertainment Broadcast Network, Cybertrend, Inc., Lightspeed Media Corporation, Adult Revenue Services, Innovative Ideas International, AskCS.com, Game Link, Inc., Club Jenna, Inc., Cybernet Ventures, Inc., ACMP, LLC, Global AVS, Inc. d/b/a DrewNet, and National A-1 Advertising.

***High Resolution Optics Technology***

·Theodore Whitney and High Resolution Optics Corporation v. The United States. United States Court of Federal Claims. Filed 8/23/06. Case No. 1:06-cv-00601.

***Interactive Television Technology***

·Broadcast Innovation, LLC and IO Research, Ltd. v. Charter Communications, Inc. United States District Court for the District of Colorado. Case No. 1:03-cv-02223. On appeal to the U.S. Court of Appeals for the Federal Court from 9/28/04 to 11/21/05. Remanded to the U. S. District Court for further proceedings on 11/21/05.

·Broadcast Innovation, LLC v. Echostar Communications Corporation. United States District Court for the District of Colorado. Filed 11/9/01. Case No. 1:01-cv-02201.

***Micromesh Technology***

·Micromesh Technology Corporation v. American Recreation Productions, Inc., and American Recreation Products, Inc., dba Kelty. United States District Court for the Northern District of California. Filed 9/27/06. Case No. 3:06-cv-06030.

·Micromesh Technology Corporation v. Columbia Sportswear Company. United States District Court for the Northern District of California. Filed 9/27/06. Case No.5:06-cv-06031.

·Micromesh Technology Corporation v. Red Wing Shoe Company and Red Wing Shoe Company, dba Vasque. United States District Court for the Eastern District of Texas. Filed 10/4/06. Case No. 2:06-cv-00421.

·Micromesh Technology Corporation v. VF Corporation, VF Corporation, dba JanSport, VF Outdoor, Inc., dba The North Face. United States District Court for the Eastern District of Texas. Filed 10/4/06. Case No. 2:06-cv-00422.

***Microprocessor Enhancement Technology***

- Microprocessor Enhancement Corporation and Michael H. Branigin v. Texas Instruments, Inc. United States District Court for the Central District of California. Filed 4/7/05. Case No. 8:05-cv-00323.
- Microprocessor Enhancement Corporation and Michael H. Branigin v. Intel Corporation. United States District Court for the Central District of California. Filed 8/3/05. Case No. 2:05-cv-05667.

***Multi-Dimensional Bar Code Technology***

- Cognex Corporation v. VCode Holdings, Inc., VData, LLC, Acacia Research Corporation, and Veritec Inc. United States District Court for the District of Minnesota. Filed 3/13/06. Case No. 0:06-cv-01040.
- VData, LLC and VCode Holdings, Inc. v. Aetna, Inc., PNY Technologies Inc., and Merchant's Credit Guide Co. United States District Court for the District of Minnesota. Filed 5/8/06. Case No. 0:06-cv-01701.

***Peer to Peer Communications Technology***

- Peer Communications Corporation v. Skype Technologies SA, Skype, Inc., and eBay, Inc. United States District Court for the Eastern District of Texas. Filed 8/22/06. Case No. 6:06-cv-00370.

***Product Activation Technology***

- Product Activation Corporation v. Abbyy USA Software House, Inc., Adobe Systems Inc., Autodesk, Inc. United States District Court for the Eastern District of Texas. Filed 8/14/06 Case No. 2:06-cv-00326.

***Resource Scheduling Technology***

- Epic Systems Corporation v. Acacia Research Corporation and Resource Scheduling Corporation. United States District Court for the District of Delaware. Filed 4/19/06. Case No. 1:06-cv-00255.

***Spreadsheet Automation Technology***

- Spreadsheet Automation Corporation v. Microsoft Corporation. United States District Court for the Eastern District of Texas. Filed 3/28/05. Case No. 2:05-cv-00127.

***User Activated Internet Advertising Technology***

- InternetAd Systems, LLC v. Turner Broadcasting System, Inc., Freerealttime.com, Inc., Knight Ridder Digital, Homestore, Inc., Condenet, Inc. and Tribune Company. United States District Court for the North District of Texas. Filed 6/15/06. Case No. 3:06-cv-01063.
- InternetAd Systems, LLC v. Opodo Limited, Amadeus Global Travel Distribution S.A., Amadeus North America, LLC, and Best Western International, Inc. United States District Court for the North District of Texas. Filed 6/19/06. Case No. 3:06-cv-01084.

In connection with the Acacia Technologies group's patent enforcement activities, we may be subject to certain claims, counterclaims and legal actions that arise in the ordinary course of our patent enforcement activities. Management believes that the ultimate liability with respect to these claims and legal actions, if any, will not have a material effect on our financial position, results of operations or cash flows.

**Critical Accounting Estimates**

Our unaudited interim financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. Preparation of these statements requires management to make judgments and estimates. Some accounting policies have a significant impact on amounts reported in these financial statements. A summary of significant accounting policies and a description of accounting policies that are considered critical may be found in our 2005 Annual Report on Form 10-K, filed on March 16, 2006, in the Notes to the Consolidated



Financial Statements and the Critical Accounting Estimates section. In addition, refer to Note 2 to the consolidated interim financial statements included in Part I, Item 1 of this report.

*Stock-based Compensation Expense*

Effective January 1, 2006, Acacia Research Corporation adopted the provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123R"), which is a revision of SFAS No. 123, "Accounting for Stock-Based Compensation." SFAS No. 123R supersedes Accounting Principles Board ("APB") Opinion No. 25, Accounting for Stock Issued to Employees, and amends SFAS No. 95, "Statement of Cash Flows." SFAS No. 123R sets forth the accounting requirements for "share-based" compensation payments to employees and non-employee directors and requires all share based-payments to be recognized as expense in the statement of operations. In March 2005, the SEC published Staff Accounting Bulletin No. 107 ("SAB 107"), which requires stock-based compensation to be classified in the same expense line items as cash compensation (i.e. marketing, general and administrative and research and development expenses). The compensation cost for all stock-based awards is measured at the grant date, based on the fair value of the award (determined using a Black-Scholes option pricing model), and is recognized as an expense over the employee's requisite service period (generally the vesting period of the equity award). Determining the fair value of stock-based awards at the grant date requires significant estimates and judgments, including estimating the market price volatility of our classes of common stock and employee stock option exercise behavior.

SFAS No. 123R also requires stock-based compensation expense to be recorded only for those awards expected to vest using an estimated pre-vesting forfeiture rate. As such, SFAS No. 123R requires Acacia Research Corporation to estimate pre-vesting option forfeitures at the time of grant and reflect the impact of estimated pre-vesting option forfeitures on compensation expense recognized. Estimates of pre-vesting forfeitures must be periodically revised in subsequent periods if actual forfeitures differ from those estimates. We consider several factors in connection with our estimate of pre-vesting forfeitures including types of awards, employee class, and historical pre-vesting forfeiture data. The estimation of stock awards that will ultimately vest requires judgment, and to the extent that actual results differ from our estimates, such amounts will be recorded as cumulative adjustments in the period the estimates are revised. If actual results differ significantly from these estimates, stock-based compensation expense and our results of operations could be materially impacted.

Refer to Notes 2 and 9 to the Acacia Research Corporation consolidated financial statements included in Part I, Item 1 of this report for more information.

**Acacia Research Corporation Consolidated  
Comparison of the Results of Operations for the Three and Nine Months Ended September 30, 2006 and 2005**

**Net Loss (In thousands)**

	<b>For the Three Months Ended</b>		<b>For the Nine Months Ended</b>	
	<b>September 30,</b>	<b>September 30,</b>	<b>September 30,</b>	<b>September 30,</b>
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Net loss	\$ (5,376)	\$ (5,441)	\$ (17,817)	\$ (15,808)

The changes in net loss were primarily due to operating results and activities as discussed below.

**Revenues and Cost of Revenues (In thousands)**

	<b>For the Three Months Ended</b>		<b>For the Nine Months Ended</b>	
	<b>September 30,</b>	<b>September 30,</b>	<b>September 30,</b>	<b>September 30,</b>
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
License fees	\$ 8,424	\$ 6,783	\$ 27,512	\$ 11,328
Government contract	725	973	1,563	2,985
Cost of government contract revenues	(684)	(920)	(1,476)	(2,820)
Products	968	453	3,050	1,298
Cost of product sales	(412)	(282)	(973)	(635)
Service contracts	151	37	268	106

*License Fees.* Revenues for the three months ended September 30, 2006 included license fees from 10 new licensing agreements covering 7 of our technology licensing programs, as compared to 32 new licensing agreements covering 9 of our technology licensing programs in the comparable 2005 period. Revenues for the nine months ended September 30, 2006 included license fees from 58 new licensing agreements covering 12 of our technology licensing programs, as compared to 61 new licensing agreements covering 11 of our technology licensing programs in the comparable 2005 period. License fee revenues recognized by the Acacia Technologies group fluctuate from period to period primarily based on the following factors:

- the dollar amount of agreements executed each period, which is primarily driven by the nature and characteristics of the technology being licensed and the magnitude of infringement associated with a specific licensee;

the specific terms and conditions of agreements executed each period and the periods of infringement contemplated by the respective payments;

fluctuations in the total number of agreements executed;

fluctuations in the sales results or other royalty per unit activities of our licensees that impact the calculation of license fees due;

the timing of the receipt of periodic license fee payments and/or reports from licensees; and

fluctuations in the net number of active licensees period to period.

Costs incurred in connection with the Acacia Technologies group's ongoing licensing activities, other than inventor royalties expense and contingent legal fees expense, are included in marketing, general and administrative expenses.

*Government Contract and Cost of Government Contract Revenues.* The decrease was due to the completion, in December 2005, of the CombiMatrix group's commitments under its previous two-year, \$5.9 million research and development contract with the DoD to further the development of the CombiMatrix group's array technology for the electrochemical detection of biological threat agents. In February 2006, the CombiMatrix group executed a new one-year, \$2.1 million contract with the DoD to further the development of its electrochemical detection system. Government contract revenues and contract costs were lower during the three and nine months ended September 30, 2006, as compared to the three and nine months ended September 30, 2005, due to the commencement of work under the new \$2.1 million contract in February 2006, as compared to nine full months of activity under the previous \$5.9 million contract during the prior year. In August 2006, the CombiMatrix group executed a new two-year, \$1.9 million contract with the DoD to integrate its electrochemical detection technology with its microfluidics "lab-on-a-chip" technology for national defense and homeland security applications. Efforts under the microfluidics contract were not significant during the three months ended September 30, 2006.

Under the terms of its DoD contracts, the CombiMatrix group is reimbursed on a periodic basis for actual costs incurred to perform its obligations, plus a fixed fee. Revenues are recognized under the percentage-of-completion method of accounting, using the cost-to-cost approach to measure completeness at the end of each reporting period. Cost of government contract revenues reflect research and development expenses incurred in connection with the CombiMatrix group's commitments under its current contracts with the DoD, which were approximately 68% and 4% complete as of September 30, 2006 for the electrochemical detection and microfluidics contracts, respectively.

*Product Revenues and Cost of Product Sales.* Product revenues and costs of product sales relate to domestic and international sales of the CombiMatrix group's array products. Product revenues include the sale of DNA synthesizer instruments and CustomArray 12K DNA expression arrays and related hardware including array revenue from our diagnostics subsidiary, CMDX, during the nine months ended September 30, 2006, compared to lower instrument and 12K DNA expression array sales during the comparable quarter in 2005. The overall increase in product revenues was due primarily to the increased product offerings currently available to the CombiMatrix group's customers, which includes 12K and 4X2K arrays, DNA synthesizer and electrochemical detection reader instruments and related hardware, as compared to only the 902 and 12K expression arrays and DNA synthesizer instruments in the comparable 2005 quarters. For the three and nine months ended September 30, 2006, product revenues includes \$153,000 and \$221,000 in array sales, respectively, from our diagnostics subsidiary, CMDX, compared to no sales in the comparable 2005 periods. The increase in gross margins was due primarily to the impact of the mix of product sales during the periods presented. Revenues for the three and nine months ended September 30, 2006 included a higher percentage of product revenues from the sale of DNA synthesizer and electrochemical detection reader instruments, which generally have higher gross margins than the expression array products.

#### **Operating Expenses (In thousands)**

	<b>For the Three Months Ended</b>		<b>For the Nine Months Ended</b>	
	<b>September 30,</b>	<b>September 30,</b>	<b>September 30,</b>	<b>September 30,</b>
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Research and development expenses (including non-cash stock compensation expense of \$311 and \$797 for the three and nine months ended September 30, 2006 and \$0 for the three and nine months ended September 30, 2005)	\$ 2,819	\$ 1,527	\$ 7,380	\$ 4,082

*Research and Development Expenses.* During the three and nine months ended September 30, 2006 and 2005, the CombiMatrix group continued internal research and development efforts to improve and expand the CombiMatrix group's technology and product offerings. The increase in internal research and development expenses was due primarily to the development of higher density array products by the CombiMatrix group as well as the impact of the CombiMatrix group's diagnostics subsidiary, CMDX, which was formed and began research and development activities in the second quarter of 2005. The increase also reflects \$311,000 and \$797,000 for the three and nine months ended September 30, 2006 in non-cash stock compensation charges recorded in connection with the adoption of SFAS No. 123R, effective January 1, 2006, as described above under "*Critical Accounting Estimates.*"

Future research and development expenses will continue to be incurred in connection with the CombiMatrix group's ongoing internal research and development efforts in the areas of genomics, diagnostics, drug discovery and development. The CombiMatrix group expects its research and development expenses to continue to fluctuate and such expenses could increase in future periods as additional internal research and development programs are undertaken and/or as new research and development collaborations are executed with strategic partners.

	For the Three Months Ended		For the Nine Months Ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Marketing, general and administrative expenses (including non-cash stock compensation expense of \$1,262 and \$3,881 for the three and nine months ended September 30, 2006 and \$88 and (\$23) for the three and nine months ended September 30, 2005)	\$ 6,315	\$ 4,918	\$ 20,086	\$ 12,957
Legal expenses - patents	2,354	1,076	3,803	2,173
Inventor royalties and contingent legal fees expense - patents	2,623	3,939	12,741	5,706
Amortization of patents	1,596	1,607	4,813	4,407
Write-off of patent-related intangible asset	-	-	297	-
Loss from equity investment	253	100	786	202

*Marketing, General and Administrative Expenses.* The increase primarily reflects Acacia Research Corporation's adoption of SFAS No. 123R, effective January 1, 2006, which requires public companies to measure all employee stock-based compensation awards using a fair-value method and record such expense in their consolidated financial statements, as described under "Critical Accounting Estimates." Non-cash stock compensation charges included in marketing, general and administrative expense for the three and nine months ended September 30, 2006 totaled \$1,262,000 and \$3,881,000, respectively, as compared to \$88,000 and a credit of \$23,000 for the three and nine months ended September 30, 2005, respectively.

Excluding the impact of the adoption of SFAS No. 123(R), the increase in marketing, general and administrative expenses was due primarily to the addition of licensing, business development and engineering personnel for the Acacia Technologies group and an increase in corporate, general and administrative costs related to the Acacia Technologies group's ongoing operations. The change also reflects an increase in general and administrative expenses incurred by the CombiMatrix group in connection with the ongoing operations of CMDX and an increase in other general and administrative expenses related to ongoing operations.

A summary of the main drivers of the change in marketing, general and administrative expenses for the periods presented is as follows (in thousands):

	For the Three Months Ended 2006 vs. 2005		For the Nine Months Ended 2006 vs. 2005	
CombiMatrix group:				
Decrease in marketing and sales expenses	\$	(313)	\$	(836)
(Decrease) increase in general and administrative expenses related to CMDX		(46)		1,292
Increase in legal, accounting and other professional fees		183		1,106
Decrease in other general and administrative expenses		(188)		(198)

Acacia Technologies group:			
Increase in personnel expenses	\$	406	\$ 1,086
Increase in legal, accounting and other professional fees		142	399
Increase in other general and administrative expenses		39	376

*Legal Expense - Patents (Acacia Technologies group only).* Patent-related legal expenses include patent-related prosecution and enforcement costs incurred by outside patent attorneys engaged on an hourly basis and the out-of-pocket expenses incurred by law firms engaged on a contingent fee basis. Patent-related legal expenses fluctuate from period to period based on patent enforcement and prosecution activity associated with ongoing licensing and enforcement programs and the timing of the commencement of new licensing and enforcement programs in each period. Patent-related legal expenses include case related costs billed by outside counsel for economic analyses and damages assessments, expert witnesses and other consultants, case related audio/video presentations for the court, and other litigation support and administrative costs. Refer to “Patent Enforcement Litigation” above. We expect patent-related legal expenses to continue to fluctuate period to period based on the factors summarized above in connection with the Acacia Technologies group’s current and future patent commercialization and enforcement programs.

*Inventor Royalties and Contingent Legal Fees Expense.* During the three and nine months ended September 30, 2006, the Acacia Technologies group incurred inventor royalty expenses of \$1.8 million and \$7.1 million, respectively, as compared to \$2.1 million and \$2.9 million for the three and nine months ended September 30, 2005. Contingent legal fees expenses incurred during the three and nine months ended September 30, 2006 were \$786,000 and \$5.6 million, respectively, as compared to \$1.8 million and \$2.8 million during the three and nine months ended September 30, 2005. The majority of the Acacia Technologies group’s patent portfolios are subject to patent and patent rights agreements with inventors containing provisions granting to the original patent owner the right to receive inventor royalties based on future net revenues, as defined in the respective agreements and may also be subject to contingent legal fee arrangements with external law firms engaged on a contingent fee basis. The economic terms of the inventor and contingent arrangements, if any, vary across the Acacia Technologies group’s 52 patent portfolios. As such, inventor royalties and contingent legal fees expenses fluctuate period to period based on the amount of revenues recognized each period and the mix of specific patent portfolios generating revenues each period.

*Amortization of Patents.* The year to date increase was due primarily to nine full months of patent amortization expense resulting from the January 28, 2005 GPH Acquisition for the nine months ended September 30, 2006, as compared to eight months of amortization in comparable 2005 period. In addition, amortization expense includes additional charges related to certain of the patent portfolios acquired by the Acacia Technologies group subsequent to September 30, 2005. Patent amortization charges will continue to be significant in future periods as the Acacia Technologies group continues to amortize acquired patent related costs over a weighted average remaining economic useful life of approximately 5 years.

*Write-off of Patent-related Intangible Asset.* In June 2006, the Acacia Technologies group recorded a non-cash impairment charge of \$297,000, related to the write-off of a patent-related intangible asset. During the second quarter of 2006, pursuant to the terms of the respective license agreement, management elected to terminate its rights to exclusively license and enforce the patent, resulting in the write-off of the remaining carrying value of the patent-related intangible asset as of June 30, 2006.

*Loss from Equity Investment.* As of September 30, 2006 and 2005, the CombiMatrix group owned 29% and 14%, respectively, of Leuchemix Inc., or Leuchemix, a private drug development firm, which is developing several compounds for the treatment of leukemia and other cancers. The CombiMatrix group's equity in the losses of Leuchemix increased due to the CombiMatrix group's increased ownership in Leuchemix as well as an increase in expenses incurred by Leuchemix. The CombiMatrix group is under a contractual commitment to increase ownership to approximately 33% during the fourth quarter of 2006 and as a result, equity in loss of Leuchemix is expected to increase in future periods.

## **Other**

*Warrant Gains (Charges).* In accordance with SFAS No. 150, "Accounting for Certain Instruments with Characteristics of Both Liabilities and Equity," or SFAS No. 150, and related interpretations, certain AR-CombiMatrix stock purchase warrants outstanding at September 30, 2006 have been classified as a long-term liability due to certain redemption provisions associated with the underlying AR-CombiMatrix stock. Changes in the fair value of the stock purchase warrant liability are reflected in the statement of operations. Refer to Note 8 to the Acacia Research Corporation consolidated financial statements in Part I, Item 1 of this report.

*Loss on Sale of Investment.* In January 2006, the CombiMatrix group expanded its relationship with one of its existing distributors, InBio, for the Asia Pacific region. Major components of the expanded relationship included the transfer of day-to-day operational responsibility and majority ownership of CombiMatrix K.K. to InBio, along with an expanded distribution agreement that encompasses Japan. InBio obtained 67% of the voting interests in CombiMatrix K.K. for a nominal amount of consideration. As a result, InBio assumed all operational and financial responsibilities of CombiMatrix K.K. The net loss on the sale of 67% of the voting interest in CombiMatrix K.K. was \$84,000. Subsequent to the sale, the CombiMatrix group's investment in CombiMatrix K.K. was accounted for under the equity method. The deconsolidation of CombiMatrix K.K. did not have a material impact on the consolidated or CombiMatrix group balance sheets as of September 30, 2006. The impact on the statement of operations resulting from the transition to the equity method of accounting for the CombiMatrix group's investment in CombiMatrix K.K. was not material during the periods presented.

*Estimated Loss on Discontinued Operations.* Results for the nine months ended September 30, 2005, include a \$210,000 charge, net of minority interests, related to estimated additional costs to be incurred in connection with the discontinued operations of Soundbreak.com (originally ceased operations in February 2001), related primarily to certain noncancellable lease obligations and a reduction in estimated amounts recoverable from existing sublease arrangements. The related lease obligations expired in August 2005.

## **Inflation**



Inflation has not had a significant impact on Acacia Research Corporation.

### **Liquidity and Capital Resources**

Acacia Research Corporation's consolidated cash and cash equivalents and short-term investments totaled \$54.3 million at September 30, 2006, compared to \$59.2 million at December 31, 2005. Working capital at September 30, 2006, was \$49.9 million, compared to \$58.1 million at December 31, 2005. The change in working capital was due primarily to the impact of net cash flow activities as discussed below.

51

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The net increase (decrease) in cash and cash equivalents for the nine months ended September 30, 2006, and 2005 was comprised of the following (in thousands):

	For the Nine Months Ended September 30, 2006			For the Nine Months Ended September 30, 2005		
	Acacia Technologies Group	CombiMatrix Group	Consolidated	Acacia Technologies Group	CombiMatrix Group	Consolidated
	Net cash provided by (used in):					
Operating activities (including discontinued operations of \$222 in 2006 and (\$525) in 2005)	\$ 8,149	\$ (11,848)	\$ (3,699)	\$ (865)	\$ (9,954)	\$ (10,819)
Investing activities (including discontinued operations of (\$353) in 2006)	2,515	6,266	8,781	(17,729)	11,177	(6,552)
Financing activities	325	2,220	2,545	19,572	12,969	32,541
Effect of exchange rate on cash	-	-	-	-	35	35
Increase (decrease) in cash and cash equivalents	\$ 10,989	\$ (3,362)	\$ 7,627	\$ 978	\$ 14,227	\$ 15,205

Cash receipts from licensees for the Acacia Technologies group for the nine months ended September 30, 2006, increased to \$30.2 million from \$11.3 million in the comparable 2005 period, reflecting the increase in license fee revenues recognized in 2006 compared to 2005. Cash outflows from operations for the Acacia Technologies group for the nine months ended September 30, 2006, increased to \$22.1 million from \$12.2 million in the comparable 2005 period, due to increases in inventor royalties expenses and contingent legal fees expenses, personnel expenses, corporate, general and administrative expenses, as described above, and the impact of the timing of payments and related accruals.

Cash receipts from customers for the CombiMatrix group for the nine months ended September 30, 2006, were \$4.5 million, comprised of \$2.6 million from the sale of array products and services and \$1.9 million in payments received from the DoD. Cash receipts in the comparable 2005 period totaled \$4.1 million, comprised of \$3.0 million in biological threat detection contract payments received from the Department of Defense and \$1.1 million from the sale of array products and related services. Cash outflows from operations for the CombiMatrix group for the nine months ended September 30, 2006, increased to \$16.3 million, as compared to \$14.1 million in the comparable 2005 period, due primarily to an increase in research and development, marketing, general and administrative expenses related to CMDX as described above, and the impact of the timing of vendor payments and related accruals.

The change in net cash flows used in investing activities was due to net purchases and sales of available-for-sale investments by the Acacia Technologies group and the CombiMatrix group, respectively, in connection with ongoing short-term cash management activities. Net cash outflows from investing activities for the nine months ended September 30, 2006 also included Acacia Technologies group patent related acquisitions costs totaling \$1.0 million and the CombiMatrix group's additional contractual investment in Leuchemix totaling \$1.4 million. Net cash outflows from investing activities for the nine months ended September 30, 2005 included the cash consideration and related acquisition and registration costs paid by the Acacia Technologies group in connection with the GPH Acquisition and the CombiMatrix group's additional contractual investment in Leuchemix of \$1.1 million. Fixed asset purchases for the nine months ended September 30, 2006 and 2005, primarily related to the CombiMatrix group were \$619,000 and

\$1.2 million, respectively. In addition, in April 2006, a final distribution to Soundbreak.com's minority shareholders was paid totaling \$353,000.

Net cash flows provided by financing activities during the nine months ended September 30, 2006 included proceeds from the exercise of AR-Acacia Technologies stock options of \$455,000. Net cash flows provided by financing activities during the nine months ended September 30, 2005 included net proceeds of approximately \$19.5 million from the sale of 3.5 million shares of AR-Acacia Technologies stock in a registered direct offering.

Net cash flows provided by financing activities during the nine months ended September 30, 2006 also included \$2.1 million in proceeds from the Standby Equity Distribution Agreement with Cornell Capital Partners, LP, which may provide up to \$50 million of equity financing from Cornell through the sale of AR-CombiMatrix common stock through June 2008. As of November 2, 2006, 9,813,579 shares of AR-CombiMatrix common stock are available under the SEDA. Refer to "CombiMatrix Group Management's Discussion and Analysis - Liquidity and Capital Resources" for a more detailed discussion of the CombiMatrix group's liquidity and capital resources.

The cash and cash equivalent balances, anticipated cash flow from operations, and other external sources of available credit of the Acacia Technologies group and the CombiMatrix group are discussed separately below. The cash and cash equivalent balances, anticipated cash flow from operations, and other external sources of available credit of one group are not generally available to the other group, and therefore, a discussion of the sufficiency of these resources on a consolidated basis is not meaningful. Please carefully review the discussion of the sufficiency of these resources under the heading "Liquidity and Capital Resources" within the discussion of each operating group below.

Acacia Research Corporation's cash and cash equivalent and short term investment balances, cash flows and anticipated cash flows from operations and other sources of external credit, are attributed to the Acacia Technologies group and the CombiMatrix group based on the respective assets of the specific businesses comprising each group. Issuances of AR-Acacia Technologies stock (and the proceeds thereof) are attributed to the Acacia Technologies group and issuances of AR-CombiMatrix stock (and the proceeds thereof) are attributed to the CombiMatrix group. Neither of the groups is obligated to fund the ongoing operations of the other group. Management has no intent to use the cash and cash equivalent balances, anticipated cash flow from operations, and other external sources of available credit of one group to fund the ongoing operations of the other group.

### Off-Balance Sheet Arrangements

We have not entered into off-balance sheet financing arrangements, other than operating leases. We have no significant commitments for capital expenditures in 2006 and 2007. Other than as set forth below, we have no committed lines of credit or other committed funding or long-term debt. The following table lists our material known future cash commitments as of September 30, 2006:

Contractual Obligations	Payments Due by Period (in thousands)				
	Remaining 2006	2007	2008	2009	2010 and Thereafter
Operating leases	\$ 561	\$ 2,489	\$ 2,180	\$ 588	\$ 1,355
Minimum royalty payments <sup>(1)</sup>	25	100	100	100	875
Leuchemix equity purchases <sup>(2)</sup>	750	-	-	-	-
Consulting contract <sup>(3)</sup>	289	99	-	-	-
Total contractual cash obligations	\$ 1,625	\$ 2,688	\$ 2,280	\$ 688	\$ 2,230

(1) Refer to Note 10 to the Acacia Research Corporation consolidated financial statements for a description of the September 30, 2002 settlement agreement between CombiMatrix Corporation and Dr. Donald Montgomery and Nanogen.

(2) Refer to Note 10 to the Acacia Research Corporation consolidated financial statements included in Part I, Item 1 of this report for additional information regarding the October 2004 Leuchemix transaction.

(3) Reflects January 2005 \$2.0 million consulting contract commitment, including reimbursable expenses, to be paid over two years in connection with the Acacia Technologies group's GPH Acquisition, as described above.

In connection with the acquisition of certain patents and patent rights, certain companies included in the Acacia Technologies group executed related agreements which grant to the former owners of the respective patents or patent rights, the right to receive royalties based on future net license fee revenues (as defined in the respective agreements) generated by the Acacia Technologies group as a result of licensing the respective patents or patent portfolios. Royalties paid pursuant to the agreements are expensed in the consolidated statement of operations in the period that the related license fee revenues are recognized.

### Recent Accounting Pronouncements

Refer to Note 5 to the Acacia Research Corporation consolidated financial statements included in Part I, Item 1 of this report.

### **Quantitative and Qualitative Disclosures About Market Risk**

Our exposure to market risk is limited primarily to interest income sensitivity, which is affected by changes in the general level of United States interest rates, particularly because a significant portion of our investments are in short-term debt securities issued by the U.S. government, U.S. corporations, institutional money market funds and other money market instruments. The primary objective of our investment activities is to preserve principal while at the same time maximizing the income received without significantly increasing risk. To minimize risk, we maintain a portfolio of cash, cash equivalents and short-term investments in a variety of investment-grade securities and with a variety of issuers, including corporate notes, commercial paper and money market instruments. Due to the nature of our short-term investments, we believe that we are not subject to any material market risk exposure. We do not have any derivative financial instruments.

**DISCUSSION OF SEGMENTS' OPERATIONS, FINANCIAL RESOURCES AND LIQUIDITY****ACACIA TECHNOLOGIES GROUP MANAGEMENT'S DISCUSSION AND ANALYSIS  
(A Division of Acacia Research Corporation)**

*You should read this discussion in conjunction with the Acacia Technologies group financial statements and related notes and the Acacia Research Corporation consolidated financial statements and related notes, both included in Part I, Item 1 of this report. Historical results and percentage relationships are not necessarily indicative of operating results for any future periods.*

**General**

Refer to Item 2. "Management's Discussion and Analysis of Financial Condition and Results of Operations - Overview," for a general overview of the Acacia Technologies group's business.

Although the AR-Acacia Technologies stock is intended to reflect the separate performance of the Acacia Technologies group, rather than the performance of Acacia Research Corporation as a whole, the Acacia Technologies group is not a separate legal entity. Holders of the AR-Acacia Technologies stock are stockholders of Acacia Research Corporation. As a result, they continue to be subject to all of the risks of an investment in Acacia Research Corporation and all of Acacia Research Corporation's businesses, assets and liabilities. The assets Acacia Research Corporation attributes to the Acacia Technologies group could be subject to the liabilities of the CombiMatrix group. Refer to Note 1 to our consolidated financial statements included in Part I, Item 1 of this report for details regarding our separate group presentation and our classes of common stock.

**Acacia Technologies Group****(A Division of Acacia Research Corporation)****Comparison of the Results of Operations for the Three and Nine Months Ended September 30, 2006 and 2005****Division Net Loss (In thousands)**

	<b>For the Three Months Ended</b>		<b>For the Nine Months Ended</b>	
	<b>September 30,</b>	<b>September 30,</b>	<b>September 30,</b>	<b>September 30,</b>
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Division net loss	\$ (1,049)	\$ (1,558)	\$ (2,359)	\$ (5,192)

The changes in net loss were primarily due to operating results and activities as discussed below.

**Revenues (In thousands)**

	<b>For the Three Months Ended</b>		<b>For the Nine Months Ended</b>	
	<b>September 30,</b>	<b>September 30,</b>	<b>September 30,</b>	<b>September 30,</b>
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
License fees	\$ 8,424	\$ 6,783	\$ 27,512	\$ 11,328

*License Fees.* Revenues for the three months ended September 30, 2006 included license fees from 10 new licensing agreements covering 7 of our technology licensing programs, as compared to 32 new licensing agreements covering 9 of our technology licensing programs in the comparable 2005 period. Revenues for the nine months ended September 30, 2006 included license fees from 58 new licensing agreements covering 12 of our technology licensing programs, as compared to 61 new licensing agreements covering 11 of our technology licensing programs in the comparable

2005 period. License fee revenues recognized fluctuate from period to period primarily based on the following factors:

- the dollar amount of agreements executed each period, which is primarily driven by the nature and characteristics of the technology being licensed and the magnitude of infringement associated with a specific licensee;
- the specific terms and conditions of agreements executed each period and the periods of infringement contemplated by the respective payments;
  - fluctuations in the total number of agreements executed;
- fluctuations in the sales results or other royalty per unit activities of our licensees that impact the calculation of license fees due;
  - the timing of the receipt of periodic license fee payments and/or reports from licensees; and
  - fluctuations in the net number of active licensees period to period.



Costs incurred in connection with the Acacia Technologies group's ongoing licensing activities, other than inventor royalties expense and contingent legal fees expense, are included in marketing, general and administrative expenses.

**Operating Expense (In thousands)**

	<b>For the Three Months Ended</b>		<b>For the Nine Months Ended</b>	
	<b>September 30,</b>	<b>September 30,</b>	<b>September 30,</b>	<b>September 30,</b>
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Marketing, general and administrative expenses (including non-cash stock compensation expense of \$985 and \$2,922 for the three and nine months ended September 30, 2006 and \$123 for the three and nine months ending September 30, 2005)	\$ 3,562	\$ 2,113	\$ 10,142	\$ 5,482
Legal expenses - patents	2,354	1,076	3,803	2,173
Inventor royalties and contingent legal fees expense - patents	2,623	3,939	12,741	5,706
Amortization of patents	1,322	1,334	3,991	3,586
Write-off of patent-related intangible asset	-	-	297	-

*Marketing, General and Administrative Expenses.* The increase is primarily due to the Acacia Technologies group's adoption of SFAS No. 123R, effective January 1, 2006, which requires public companies to measure all employee stock-based compensation awards using a fair-value method and record such expense in their consolidated financial statements, as described under "Critical Accounting Estimates." Non-cash stock compensation charges included in marketing, general and administrative expense for the three and nine months ended September 30, 2006 totaled \$985,000 and \$2.9 million, respectively, and \$123,000 for the three and nine months ended September 30, 2005.

Excluding the impact of the adoption of SFAS No. 123R, the change in marketing, general and administrative expenses was due primarily to an increase in personnel costs related to the addition of licensing, business development and engineering personnel and an increase in corporate, general and administrative costs related to ongoing operations. The net increase in other corporate, general and administrative expenses was comprised primarily of an increase in public and investor relations, office rent and other facilities costs.

A summary of the main drivers of the change in marketing, general and administrative expenses (excluding the impact of SFAS No. 123R) for the periods presented is as follows (in thousands):

	<b>For the Three Months Ended</b>		<b>For the Nine Months Ended</b>	
	<b>2006 vs. 2005</b>		<b>2006 vs. 2005</b>	
Acacia Technologies group:				
Increase in personnel expenses	\$ 406	\$ 1,086		
Increase in legal, accounting and other professional fees	142	399		
Increase in other general and administrative expenses	39	376		

*Legal Expense - Patents (Acacia Technologies group only).* Patent-related legal expenses include patent-related prosecution and enforcement costs incurred by outside patent attorneys engaged on an hourly basis and the out-of-pocket expenses incurred by law firms engaged on a contingent fee basis. Patent-related legal expenses fluctuate from period to period based on patent enforcement and prosecution activity associated with ongoing

licensing and enforcement programs and the timing of the commencement of new licensing and enforcement programs in each period. Patent-related legal expenses include case related costs billed by outside counsel for economic analyses and damages assessments, expert witnesses and other consultants, case related audio/video presentations for the court, and other litigation support and administrative costs. The Acacia Technologies group currently has 33 ongoing lawsuits involving 106 companies. We expect patent-related legal expenses to continue to fluctuate period to period based on the factors summarized above in connection with the Acacia Technologies group's current and future patent commercialization and enforcement programs.

*Inventor Royalties and Contingent Legal Fees Expense.* During the three and nine months ended September 30, 2006, the Acacia Technologies group incurred inventor royalty expenses of \$1.8 million and \$7.1 million, respectively, as compared to \$2.1 million and \$2.9 million for the three and nine months ended September 30, 2005. Contingent legal fees expenses incurred during the three and nine months ended September 30, 2006 were \$786,000 and \$5.6 million, respectively, as compared to \$1.8 million and \$2.8 million during the three and nine months ended September 30, 2005. The majority of the Acacia Technologies group's patent portfolios are subject to patent and patent rights agreements with inventors containing provisions granting to the original patent owner the right to receive inventor royalties based on future net revenues, as defined in the respective agreements and may also be subject to contingent legal fee arrangements with external law firms engaged on a contingent fee basis. The economic terms of the inventor and contingent arrangements, if any, vary across the Acacia Technologies group's 52 patent portfolios. As such, inventor royalties and contingent legal fees expenses fluctuate period to period based on the amount of revenues recognized each period and the mix of specific patent portfolios generating revenues each period.

*Amortization of Patents.* The increase was due primarily to nine full months of patent amortization expense resulting from the January 28, 2005 GPH Acquisition for the nine months ended September 30, 2006, as compared to eight months of amortization in comparable 2005 period. In addition, amortization expense includes additional charges related to certain of the patent portfolios acquired by the Acacia Technologies group subsequent to September 30, 2005. Patent amortization charges will continue to be significant in future periods as the Acacia Technologies group continues to amortize acquired patent related costs over a weighted average remaining economic useful life of approximately 5 years.

*Write-off of Patent-related Intangible Asset.* In June 2006, the Acacia Technologies group recorded a non-cash impairment charge of \$297,000, related to the write-off of a patent-related intangible asset. During the second quarter of 2006, pursuant to the terms of the respective license agreement, management elected to terminate its rights to exclusively license and enforce the patent, resulting in the write-off of the remaining carrying value of the patent-related intangible asset as of June 30, 2006.

## **Other**

*Estimated Loss on Discontinued Operations.* Results for the nine months ended September 30, 2005, include charges, net of minority interests, of \$210,000, related to estimated additional costs to be incurred in connection with the discontinued operations of Soundbreak.com (originally ceased operations in February 2001), related primarily to certain noncancellable lease obligations and a reduction in estimated amounts recoverable from existing sublease arrangements. The related lease obligations expired in August 2005.

## **Inflation**

Inflation has not had a significant impact on the Acacia Technologies group.

## **Liquidity and Capital Resources**

The Acacia Technologies group's cash and cash equivalents and short-term investments totaled \$46.0 million at September 30, 2006, compared to \$39.0 million at December 31, 2005. Working capital at September 30, 2006, was \$42.5 million, compared to \$38.9 million at December 31, 2005.

The net increase (decrease) in cash and cash equivalents for the nine months ended September 30, 2006, and 2005, was comprised of the following (in thousands):

**For the Nine Months Ended**

	<b>September 30, 2006</b>	<b>September 30, 2005</b>
Net cash provided by (used in):		
Operating activities (including discontinued operations of \$222 in 2006 and (\$525) in 2005)	\$ 8,149	\$ (865)
Investing activities (including discontinued operations of (\$353) in 2006)	2,515	(17,729)
Financing activities	325	19,572
Increase in cash and cash equivalents	\$ 10,989	\$ 978

Cash receipts from licensees for the Acacia Technologies group for the nine months ended September 30, 2006, increased to \$30.2 million from \$11.3 million in the comparable 2005 period, reflecting the increase in revenues recognized in 2006 compared to 2005. Net cash outflows from operations for the Acacia Technologies group for the nine months ended September 30, 2006, increased to \$22.1 million from \$12.2 million in the comparable 2005 period, due to increases in inventor royalties expenses and contingent legal fees expenses, personnel expenses, corporate, general and administrative expenses, as described above, and the impact of the timing of payments and related accruals.

The change in net cash flows used in investing activities for the periods presented reflects net short term investment activities in connection with ongoing short-term cash management activities. Net cash outflows from investing activities for the nine months ended September 30, 2006 also included Acacia Technologies group patent related acquisitions costs totaling \$1.0 million. Net cash outflows from investing activities for the nine months ended September 30, 2005 reflects the \$5.8 million cash consideration and related acquisition and registration costs paid in connection with the GPH Acquisition in the first quarter of 2005 and \$445,000 in other patent acquisition costs. In addition, in April 2006, a final distribution to Soundbreak.com's minority shareholders was paid totaling \$353,000.

Net cash flows provided by financing activities during the nine months ended September 30, 2006 included proceeds from the exercise of AR-Acacia Technologies stock options of \$455,000. Net cash flows provided by financing activities during the nine months ended September 30, 2005 included net proceeds of approximately \$19.5 million from the sale of 3.5 million shares of AR-Acacia Technologies stock in a registered direct offering.

Management believes that the Acacia Technologies group's cash and cash equivalent balances, anticipated cash flow from operations and other external sources of available credit, will be sufficient to meet its cash requirements through at least November 2007. The Acacia Technologies group may however encounter unforeseen difficulties that may deplete its capital resources more rapidly than anticipated, including those set forth in our Risk Factors on pages 3, 4, 12, 13 and 15 of our shelf registration statement on Form S-3 filed with the SEC on April 25, 2006, and included as Exhibit 99.1 of our Quarterly Report for the three months ended March 31, 2006, and incorporated by reference herein. Any efforts to seek additional funding could be made through equity, debt or other external financing and there can be no assurance that additional funding will be available on favorable terms, if at all. If the Acacia Technologies group fails to obtain additional funding when needed, it may not be able to execute its business plans and its business may suffer.

### Off-Balance Sheet Arrangements

The Acacia Technologies group has not entered into off-balance sheet financing arrangements, other than operating leases. The Acacia Technologies group has no significant commitments for capital expenditures in 2006 and 2007. Other than as set forth below, the Acacia Technologies group has no committed lines of credit or other committed funding or long-term debt. The following table lists the Acacia Technologies group's material known future cash commitments as of September 30, 2006:

Contractual Obligations	Remaining 2006	Payments Due by Period (in thousands)			2010 and Thereafter
		2007	2008	2009	
Operating leases <sup>(1)</sup>	\$ 89	\$ 552	\$ 565	\$ 588	\$ 1,355
Consulting contract <sup>(2)</sup>	289	99	-	-	-
Total contractual cash obligations	\$ 378	\$ 651	\$ 565	\$ 588	\$ 1,355

(1) Excludes any allocated rent expense in connection with Acacia Research Corporation's management allocation policies.

(2) Reflects January 2005 \$2.0 million consulting contract commitment, including reimbursable expenses, to be paid over two years in connection with the Acacia Technologies group's purchase of the assets of Global Patent Holdings, LLC in January 2005, as described above.

In connection with the acquisition of certain patents and patent rights, certain companies included in the Acacia Technologies group executed related agreements which grant to the former owners of the respective patents or patent rights, the right to receive royalties based on future net license fee revenues (as defined in the respective agreements) generated by the Acacia Technologies group as a result of licensing the respective patents or patent portfolios.

Royalties paid pursuant to the agreements are expensed in the consolidated statement of operations in the period that the related license fee revenues are recognized.

**Recent Accounting Pronouncements**

Refer to Note 5 to the Acacia Research Corporation consolidated financial statements included in Part I, Item 1 of this report.

**Quantitative and Qualitative Disclosures About Market Risk**

The Acacia Technologies group's exposure to market risk is limited primarily to interest income sensitivity, which is affected by changes in the general level of United States interest rates, particularly because a significant portion of our investments are in short-term debt securities issued by United States corporations, institutional money market funds and other money market instruments. The primary objective of our investment activities is to preserve principal while at the same time maximizing the income received without significantly increasing risk. To minimize risk, we maintain a portfolio of cash, cash equivalents and short-term investments in a variety of investment-grade securities and with a variety of issuers, including U.S. government and corporate notes and bonds, commercial paper and money market instruments. Due to the nature of our short-term investments, we believe that we are not subject to any material market risk exposure. We do not have any derivative financial instruments.

**COMBIMATRIX GROUP MANAGEMENT'S DISCUSSION AND ANALYSIS**  
**(A Division of Acacia Research Corporation)**

*You should read this discussion in conjunction with the CombiMatrix group financial statements and related notes and the Acacia Research Corporation consolidated financial statements and related notes, both included in Part I, Item 1 of this report. Historical results and percentage relationships are not necessarily indicative of operating results for any future periods.*

**General**

Refer to Item 2. "Management's Discussion and Analysis of Financial Condition and Results of Operations - Overview," for a general overview of the CombiMatrix group's business.

Although AR-CombiMatrix stock is intended to reflect the separate performance of the CombiMatrix group, rather than the performance of Acacia Research Corporation as a whole, the CombiMatrix group is not a separate legal entity. Holders of AR-CombiMatrix stock are stockholders of Acacia Research Corporation. As a result, they continue to be subject to all of the risks of an investment in Acacia Research Corporation and all of its businesses, assets and liabilities. The assets Acacia Research Corporation attributes to the CombiMatrix group could be subject to the liabilities of the Acacia Technologies group. Refer to Note 1 to our consolidated financial statements included in Part I, Item 1 of this report for details regarding our separate group presentation and our classes of common stock.

**CombiMatrix Group**

**(A Division of Acacia Research Corporation)**

**Comparison of the Results of Operations for the Three and Nine Months Ended September 30, 2006 and 2005**

**Division Net Loss (In thousands)**

	<b>For the Three Months Ended</b>		<b>For the Nine Months Ended</b>	
	<b>September 30,</b>	<b>September 30,</b>	<b>September 30,</b>	<b>September 30,</b>
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Division net loss	\$ (4,327)	\$ (3,883)	\$ (15,458)	\$ (10,616)

The changes in net loss were primarily due to operating results and activities as discussed below.

**Revenues and Cost of Revenues (In thousands)**

	<b>For the Three Months Ended</b>		<b>For the Nine Months Ended</b>	
	<b>September 30,</b>	<b>September 30,</b>	<b>September 30,</b>	<b>September 30,</b>
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Government contract	\$ 725	\$ 973	\$ 1,563	\$ 2,985
Cost of government contract revenues	(684)	(920)	(1,476)	(2,820)
Products	968	453	3,050	1,298
Cost of product sales	(412)	(282)	(973)	(635)
Service contracts	151	37	268	106

*Government Contract and Cost of Government Contract Revenues.* The decrease was due to the completion, in December 2005, of the CombiMatrix group's commitments under its previous two-year, \$5.9 million research and development contract with the DoD to further the development of the CombiMatrix group's array technology for the electrochemical detection of biological threat agents. In February 2006, the CombiMatrix group executed a new



one-year, \$2.1 million contract with the DoD to further the development of its electrochemical detection system. Government contract revenues and contract costs were lower during the three and nine months ended September 30, 2006, as compared to the three and nine months ended September 30, 2005, due to the commencement of work under the new \$2.1 million contract in February 2006, as compared to nine full months of activity under the previous \$5.9 million contract during the prior year. In August 2006, the CombiMatrix group executed a new two-year, \$1.9 million contract with the DoD to integrate its electrochemical detection technology with its microfluidics “lab-on-a-chip” technology for national defense and homeland security applications. Efforts under the microfluidics contract were not significant during the three months ended September 30, 2006.

Under the terms of its DoD contracts, the CombiMatrix group is reimbursed on a periodic basis for actual costs incurred to perform its obligations, plus a fixed fee. Revenues are recognized under the percentage-of-completion method of accounting, using the cost-to-cost approach to measure completeness at the end of each reporting period. Cost of government contract revenues reflect research and development expenses incurred in connection with the CombiMatrix group’s commitments under its current contracts with the DoD, which were approximately 68% and 4% complete as of September 30, 2006 for the electrochemical detection and microfluidics contracts, respectively.

*Product Revenues and Cost of Product Sales.* Product revenues and costs of product sales relate to domestic and international sales of the CombiMatrix group's array products. Product revenues include the sale of DNA synthesizer instruments and CustomArray 12K DNA expression arrays and related hardware including array revenue from our diagnostics subsidiary, CMDX, during the nine months ended September 30, 2006, compared to lower instrument and 12K DNA expression array sales during the comparable quarter in 2005. The overall increase in product revenues was due primarily to the increased product offerings currently available to the CombiMatrix group's customers, which includes 12K and 4X2K arrays, DNA synthesizer and electrochemical detection reader instruments and related hardware, as compared to only the 902 and 12K expression arrays and DNA synthesizer instruments in the comparable 2005 quarters. For the three and nine months ended September 30, 2006, product revenues includes \$153,000 and \$221,000 in array sales, respectively, from our diagnostics subsidiary, CMDX, compared to no sales in the comparable 2005 periods. The increase in gross margins was due primarily to the impact of the mix of product sales during the periods presented. Revenues for the three and nine months ended September 30, 2006 included a higher percentage of product revenues from the sale of DNA synthesizer and electrochemical detection reader instruments, which generally have higher gross margins than the expression array products.

### Operating Expenses (In thousands)

	For the Three Months Ended		For the Nine Months Ended	
	September 30,	September 30,	September 30,	September 30,
	2006	2005	2006	2005
Research and development expenses (including non-cash stock compensation expense of \$311 and \$797 for the three and nine months ended September 30, 2006 and \$0 for the three and nine months ended September 30, 2005)	\$ 2,819	\$ 1,527	\$ 7,380	\$ 4,082

*Research and Development Expenses.* During the three and nine months ended September 30, 2006 and 2005, the CombiMatrix group continued internal research and development efforts to improve and expand the CombiMatrix group's technology and product offerings. The increase in internal research and development expenses was due primarily to the development of higher density array products by the CombiMatrix group as well as the impact of the CombiMatrix group's subsidiary, CMDX, which was formed and began research and development activities in the second quarter of 2005. The increase also reflects \$311,000 and \$797,000, for the three and nine months ended September 30, 2006, in non-cash stock compensation charges recorded in connection with the adoption of SFAS No. 123R, effective January 1, 2006, as described above under "Critical Accounting Estimates."

Future research and development expenses will continue to be incurred in connection with the CombiMatrix group's ongoing internal research and development efforts in the areas of genomics, diagnostics, drug discovery and development. The CombiMatrix group expects its research and development expenses to continue to fluctuate and such expenses could increase in future periods as additional internal research and development agreements are undertaken and/or as new research and development collaborations are executed with strategic partners.

	For the Three Months Ended		For the Nine Months Ended	
	September 30,	September 30,	September 30,	September 30,
	2006	2005	2006	2005
Marketing, general and administrative expenses (including non-cash stock	\$ 2,753	\$ 2,805	\$ 9,944	\$ 7,475

compensation expense of \$277 and \$959 for the three and nine months ended September 30, 2006 and (\$35) and (\$146) for the three and nine months ended September 30, 2005)				
Loss from equity investment	253	100	786	202

*Marketing, General and Administrative Expenses.* Contributing to the change for the periods presented is the CombiMatrix group's adoption of SFAS No. 123R, effective January 1, 2006, which requires public companies to measure all employee stock-based compensation awards using a fair-value method and record such expense in their consolidated financial statements, as described under "Critical Accounting Estimates." Non-cash stock compensation charges included in marketing, general and administrative expense for the three and nine months ended September 30, 2006 totaled \$277,000 and \$959,000, respectively, as compared to a credit of \$35,000 and a credit of \$146,000 for the three and nine months ended September 30, 2005.

Excluding the impact of the adoption of SFAS No. 123R, the overall decrease in marketing, general and administrative expenses for the three months ended September 30, 2006 vs. the comparable 2005 period was due primarily to decreases in marketing and sales expenses caused by a reduction in sales and support staff, partially offset by an increase in legal and accounting expenses. For the nine months ended September 30, 2006 vs. the comparable 2005 period, overall marketing, general and administrative expenses increased due primarily to the full year's impact of general and administrative expenses incurred by CMDX in 2006, which commenced operations in the second quarter of 2005, as well as increased legal and accounting expenses related mostly to costs associated with the planned split-off of the CombiMatrix group from Acacia Research Corporation. These increases were partially offset by a decrease in marketing and sales expense.

A summary of the main drivers of the change in marketing, general and administrative expenses for the periods presented is as follows (in thousands):

	<b>For the Three Months Ended 2006 vs. 2005</b>	<b>For the Nine Months Ended 2006 vs. 2005</b>
CombiMatrix group:		
Decrease in marketing and sales expenses	\$ (313)	\$ (836)
(Decrease) increase in general and administrative expenses related to CMDX	(46)	1,292
Increase in legal, accounting and other professional fees	183	1,106
Decrease in other general and administrative expenses	(188)	(198)

*Loss from Equity Investment.* As of September 30, 2006 and 2005, the CombiMatrix group owned 29% and 14%, respectively, of Leuchemix Inc., or Leuchemix, a private drug development firm, which is developing several compounds for the treatment of leukemia and other cancers. The CombiMatrix group's equity in the losses of Leuchemix increased due to the CombiMatrix group's increased ownership in Leuchemix as well as an increase in expenses incurred by Leuchemix. The CombiMatrix group is under a contractual commitment to increase ownership to approximately 33% during the fourth quarter of 2006 and as a result, equity in loss of Leuchemix is expected to increase in future periods.

#### **Other**

*Warrant Gains (Charges).* In accordance with SFAS No. 150, "Accounting for Certain Instruments with Characteristics of Both Liabilities and Equity," or SFAS No. 150, and related interpretations, certain AR-CombiMatrix stock purchase warrants outstanding at September 30, 2006 have been classified as a long-term liability due to certain redemption provisions associated with the underlying AR-CombiMatrix stock. Changes in the fair value of the stock purchase warrant liability are reflected in the statement of operations. Refer to Note 8 to the Acacia Research Corporation consolidated financial statements in Part I, Item 1 of this report.

*Loss on Sale of Investment.* In January 2006, the CombiMatrix group expanded its relationship with one of its existing distributors, InBio, for the Asia Pacific region. Major components of the expanded relationship included the transfer of day-to-day operational responsibility and majority ownership of CombiMatrix K.K. to InBio, along with an expanded distribution agreement that encompasses Japan. InBio obtained 67% of the voting interests in CombiMatrix K.K. for a nominal amount of consideration. As a result, InBio assumed all operational and financial responsibilities of CombiMatrix K.K. The net loss on the sale of 67% of the voting interest in CombiMatrix K.K. was \$84,000. Subsequent to the sale, the CombiMatrix group's investment in CombiMatrix K.K. was accounted for under the equity method. The deconsolidation of CombiMatrix K.K. did not have a material impact on the CombiMatrix group balance sheet as of September 30, 2006. The impact on the statement of operations resulting from the transition to the equity method of accounting for the CombiMatrix group's investment in CombiMatrix K.K. was not material during the periods presented.

#### **Inflation**

Inflation has not had a significant impact on the CombiMatrix group.

#### **Liquidity and Capital Resources**

At September 30, 2006, cash and cash equivalents and short-term investments totaled \$8.3 million compared to \$20.2 million at December 31, 2005. Working capital at September 30, 2006, was \$7.3 million, compared \$19.2 million at

December 31, 2005. The change in working capital was due primarily to the impact of net cash flow activities as discussed below.

The net (decrease) increase in cash and cash equivalents for the nine months ended September 30, 2006, and 2005, was comprised of the following (in thousands):

62

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	<b>For the Nine Months Ended</b>	
	<b>September 30, 2006</b>	<b>September 30, 2005</b>
Net cash provided by (used in):		
Operating activities	\$ (11,848)	\$ (9,954)
Investing activities	6,266	11,177
Financing activities	2,220	12,969
Effect of exchange rate on cash	-	35
Increase (decrease) in cash and cash equivalents	\$ (3,362)	\$ 14,227

Cash receipts from customers for the CombiMatrix group for the nine months ended September 30, 2006, were \$4.5 million, comprised of \$2.6 million from the sale of array products and services and \$1.9 million in payments received from the Department of Defense. Cash receipts in the comparable 2005 period totaled \$4.1 million, comprised of \$1.1 million from the sale of array products and related services and \$3.0 million in electrochemical detection contract payments received from the Department of Defense. Cash outflows from operations for the CombiMatrix group for the nine months ended September 30, 2006, increased to \$16.3 million, as compared to \$14.1 million in the comparable 2005 period, due primarily to an increase in research and development, marketing general and administrative expenses related to CMDX as described above and the impact of the timing of vendor payments and related accruals.

The net cash flows provided by investing activities for the nine months ended September 30, 2006 and 2005 were due primarily to net sales of available-for-sale investments by the CombiMatrix group in connection with ongoing short-term cash management activities. For the nine months ended September 30, 2006, the CombiMatrix group incurred \$495,000 of capital expenditures and \$1.4 million in purchasing of Leuchemix preferred stock, which amounted to \$1.1 million and \$1.1 million, respectively, in the comparable 2005 period.

On June 14, 2006, Acacia Research Corporation entered into a Standby Equity Distribution Agreement (the "SEDA") with Cornell Capital Partners, LP ("Cornell"), providing up to \$50 million of equity financing from Cornell through the sale of up to 13,024,924 shares of AR-CombiMatrix common stock through June 2008. For the nine months ended September 30, 2006, the CombiMatrix group had received \$2,207,000 in net proceeds in equity financings through the sale of 2,019,646 shares of AR-CombiMatrix stock under the SEDA. For the nine months ended September 30, 2005, the CombiMatrix group's financing activities were composed primarily of two financing events. First, in July 2005, Acacia Research Corporation sold 1,400,444 shares of AR-CombiMatrix stock in a registered direct offering, generating net proceeds of approximately \$3,114,000, which were attributed to the CombiMatrix group. Second, in September 2005, Acacia Research Corporation sold 6,385,907 shares of AR-CombiMatrix stock and 1,596,478 AR-CombiMatrix stock purchase warrants in a registered direct offering, generating net proceeds of approximately \$9,707,000, which were attributed to the CombiMatrix group. We do not expect the decline in net proceeds from financing activities to continue. As discussed below, management believes the CombiMatrix group must raise additional capital to meet its cash requirements over the next 12 months, and as a result, net proceeds from financing activities should increase significantly if the CombiMatrix group is able to meet its goals over the next 12 months.

As of September 30, 2006, 11,005,278 shares of AR-CombiMatrix common stock were available under the SEDA. Subsequent to this date, an additional 1,191,699 shares of AR-CombiMatrix common stock were purchased by Cornell under the SEDA, generating net proceeds to the CombiMatrix group of \$863,000. For more information on the terms of this agreement, please refer to Note 6 of our Consolidated Financial Statements in this report and our Form 8-K filed with the Commission on June 15, 2006 and our Form 8-K filed with the Commission on June 22, 2006, incorporated herein by reference.

Management believes that the CombiMatrix group's cash and cash equivalent balances, anticipated cash flows from operations and other external sources of available credit including the SEDA will be sufficient to meet its cash requirements for the next six months. In order for the CombiMatrix group to continue as a going concern beyond March 31, 2007, the CombiMatrix group will be required to obtain capital from external sources, including the SEDA. However, based on the recent decline in the market value of AR-CombiMatrix stock, which began trading below \$1.00 per share in late September 2006, and due to the limitation of the number of shares of AR-CombiMatrix stock available on the SEDA, the CombiMatrix group may be required to seek additional sources of financing including the issuance of debt and/or equity securities that may not be available at times and at terms acceptable to the CombiMatrix group. The issuance of equity securities will also cause dilution to the AR-CombiMatrix shareholders. If external financing sources beyond the SEDA are not available or are inadequate to fund the operations of the CombiMatrix group, it will be required to reduce its operating costs including research projects and personnel, which could jeopardize the future strategic initiatives and business plans of the CombiMatrix group. For example, reductions in research and development activities and/or personnel at our Mukilteo, Washington facility could result in the inability to invest the resources necessary to continue to develop next-generation products and improve existing product lines in order to remain competitive in the marketplace, resulting in reduced revenues and cash flows from the sales of our CustomArray products and services. Also, reduction in operating costs at our diagnostics subsidiary in Irvine, California, (CMDX), should they occur, could jeopardize its ability to launch, market and sell additional products and services necessary to order grow and sustain its operations and eventually achieve profitability.

The CombiMatrix group may also encounter unforeseen difficulties that may deplete its capital resources more rapidly than anticipated, including those set forth in Part II Item 1A. "Risk Factors" in this Quarterly Report and in our Risk Factors on pages 3, 4, 5, 6, 7, 8, 9, 10, 11 and 12 of our shelf registration statement on Form S-3 filed with the SEC on April 25, 2006, included as Exhibit 99.1 of our Quarterly Report for the three and six months ended June 30, 2006, and incorporated by reference herein. Any efforts to seek additional funding could be made through equity, debt or other external financing and there can be no assurance that additional funding will be available on favorable terms, if at all.

### Off-Balance Sheet Arrangements

The CombiMatrix group has not entered into off-balance sheet financing arrangements, other than operating leases. The CombiMatrix group has no significant commitments for capital expenditures in 2006. Other than as set forth below, the CombiMatrix group has no committed lines of credit or other committed funding or long-term debt. The following table lists the CombiMatrix group's material known future cash commitments as of September 30, 2006:

Contractual Obligations	Payments Due by Period (in thousands)				
	Remaining 2006	2007	2008	2009	2010 and Thereafter
Operating leases <sup>(2)</sup>	\$ 472	\$ 1,937	\$ 1,615	\$ -	\$ -
Minimum royalty payments <sup>(1)</sup>	25	100	100	100	875
Leuchemix equity purchases <sup>(3)</sup>	750	-	-	-	-
Total contractual cash obligations	\$ 1,247	\$ 2,037	\$ 1,715	\$ 100	\$ 875

(1) Refer to Note 10 to the Acacia Research Corporation consolidated financial statements for a description of the September 30, 2002 settlement agreement between CombiMatrix Corporation and Dr. Donald Montgomery and Nanogen.

(2) Excludes any allocated rent expense in connection with Acacia Research Corporation's management allocation policies.

(3) Refer to Note 10 to the CombiMatrix group financial statements for additional information regarding the October 2004 Leuchemix transaction.

### Recent Accounting Pronouncements

Refer to Note 5 to the Acacia Research Corporation consolidated financial statements included in Part I, Item 1 of this report.

### Quantitative and Qualitative Disclosures About Market Risk

The CombiMatrix group's exposure to market risk is limited to interest income sensitivity, which is affected by changes in the general level of United States interest rates, particularly because the majority of the group's investments are in short-term debt securities issued by the U.S. treasury and by U.S. corporations. The primary objective of the group's investment activities is to preserve principal while at the same time maximizing the income the CombiMatrix group receives without significantly increasing risk. To minimize risk, the CombiMatrix group maintains its portfolio of cash, cash equivalents and short-term investments in a variety of investment-grade securities and with a variety of issuers, including corporate notes, commercial paper, government securities and money market funds. Due to the nature of its short-term investments, we believe that the CombiMatrix group is not subject to any material market risk exposure.





### **Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Refer to Item 2. "Management's Discussion and Analysis of Financial Condition and Results of Operations" under the caption "Quantitative and Qualitative Disclosures About Market Risk" for Acacia Research Corporation, the CombiMatrix group and the Acacia Technologies group, in Part I, Item 2., incorporated by reference.

### **Item 4. CONTROLS AND PROCEDURES**

#### *(a) Evaluation of disclosure controls and procedures*

The term "disclosure controls and procedures" refers to the controls and other procedures of a company that are designed to ensure that information required to be disclosed by the company in the reports that it files under the Securities Exchange Act of 1934 ("Exchange Act") is recorded, processed, summarized and reported, within required time periods specified in Commission rules and forms, and that such information is accumulated and communicated to management as appropriate to allow timely decisions regarding required disclosures.

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended. Based on this evaluation, our principal executive officer and our principal financial officer concluded that, as of the end of the period covered by this quarterly report, our disclosure controls and procedures were effective to ensure that the information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934 is accumulated and communicated to management, including our chief executive officer and chief financial officer, to allow timely decisions regarding required disclosure, and that such information is recorded, processed, summarized and reported within the time periods prescribed by the SEC.

#### *(b) Changes in Internal Control Over Financial Reporting*

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Our internal control system was designed to provide reasonable assurance to our management and board of directors regarding the reliability, preparation and fair presentation of published financial statements in accordance with generally accepted accounting principles. A material weakness (within the meaning of the Public Company Accounting Oversight Board ("PCAOB") Auditing Standard No. 2) is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

As of June 30, 2006, the end of the prior quarter, our management concluded that we did not maintain effective controls over revenue recognition. Specifically, the controls over the evaluation of certain non-standard terms and conditions contained in certain of the Acacia Technologies group's license agreements were not effective to ensure that revenue was recognized in the proper period in accordance with generally accepted accounting principles. In connection with the preparation of our Quarterly Report for the three months ended June 30, 2006, we performed additional analysis of our license agreements to ensure that revenue reported in our June 30, 2006 interim consolidated financial statements was recognized in the proper period in accordance with generally accepted accounting principles.

Management implemented additional controls and procedures, as summarized below, to specifically address the deficiency noted as of June 30, 2006. Management believes that the controls implemented are designed effectively and operated effectively during the three months ended September 30, 2006 such that the control deficiency identified above, has been fully remediated as of September 30, 2006. To remediate the above described material weakness, we implemented the following enhanced procedures and controls:

1) Management implemented enhanced procedures and controls which include an emphasis on the evaluation of revenue recognition for our license arrangements with non-standard terms and conditions.

65

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- 2) Management created and implemented the use of a Revenue Recognition checklist used by accounting staff to facilitate, document and guide the Revenue Recognition analysis under generally accepted accounting principles. The checklist addresses and provides a framework for assessing the impact of certain non-standard terms and conditions that may exist in agreements. The checklist is completed for all new license agreements and is afforded the appropriate levels of review and authorization prior to the transaction being entered into the general ledger.
- 3) Members of management with responsibility for financial statement preparation were provided informal technical training regarding Revenue Recognition under SAB 104 and other applicable guidance, specifically related to the complexities that non-standard contract language can give rise to in the analysis of appropriate revenue recognition. Management was trained to identify and more effectively assess the accounting impact of certain non-standard contract terms on revenue recognition.

Other than the enhanced controls and procedures discussed above to remediate the material weakness, there have been no changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended September 30, 2006 which our management concluded materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## **PART II--OTHER INFORMATION**

### **Item 1. LEGAL PROCEEDINGS**

Refer to Note 10 to the Acacia Research Corporation consolidated financial statements, contained in Part I, Item 1 of this report, and hereby incorporated by reference.

### **Item 1A. RISK FACTORS**

An investment in our stock involves a number of risks. Before making a decision to purchase our securities, you should carefully consider all of the risks described in this quarterly report and in our annual report on Form 10-K for the year ending December 31, 2005, filed with the Commission on March 16, 2006. If any of the risks incorporated by reference into this quarterly report or into our annual report actually occur, our business, financial condition and results of operations could be materially adversely affected. If this were to occur, the trading price of our securities could decline significantly and you may lose all or part of your investment. You should carefully review the "Risk Factors" set forth on pages 3 through 22 of our registration statement on Form S-3 filed with the Commission on April 25, 2006, included as Exhibit 99.1 of our Quarterly Report for the three months ended March 31, 2006 and hereby incorporated by reference.

You should also carefully consider the following additional risk factor not previously included in the documents incorporated by reference above:

### **RISKS RELATING TO THE COMBIMATRIX GROUP**

*Our AR-CombiMatrix stock has traded below the minimum bid price required by the Nasdaq Global Market continued listing requirements for more than thirty consecutive business days, and we may be delisted from the Nasdaq Global Market if we are unable to achieve compliance within 180 days following notice from Nasdaq.*

Since September 25, 2006, the trading price of our AR-CombiMatrix stock has been below \$1.00 per share. As a result, we have failed to meet the continued listing requirements of the Nasdaq Global Market and will likely receive a notice from Nasdaq to comply with the standards or face delisting from the exchange. As of the filing of this report,

we have not received any notice from Nasdaq. If we receive such a notice from Nasdaq, it will be publicly disclosed. Following receipt of such notice, we would have 180 days to achieve compliance with the minimum bid price standard of \$1.00 per share. If we were unable to achieve compliance within 180 days, then our AR-CombiMatrix stock would most likely be removed from trading on the Nasdaq Global Market and begin trading on the OTC Bulletin Board until we were able to meet the initial listing requirements of a Nasdaq market or another national exchange, such as Amex. If the AR-CombiMatrix stock is delisted, we would be unable to provide any assurance that we would be eligible for listing on any national exchange.

*The CombiMatrix group will not be able to meet its cash requirements over the next 12 months without obtaining additional capital from external sources, and if it is unable to do so, it may not be able to continue as a going concern.*

The CombiMatrix group's cash and cash equivalent balances, anticipated cash flows from operations and other external sources of available credit should be sufficient to meet its cash requirements through March 31, 2007. In order for the CombiMatrix group to continue as a going concern beyond March 31, 2007, the CombiMatrix group will be required to obtain capital from external sources. It is unlikely it will be able to fund all needed financing from the remaining capital available under the existing standby equity distribution agreement with Cornell Capital. If external financing sources are not available or are inadequate to fund the operations of the CombiMatrix group, it could result in reduced revenues and cash flows from the sales of our CustomArray products and services and/or could jeopardize its ability to launch, market and sell additional products and services necessary to grow and sustain its operations and eventually achieve profitability. You should review the additional information about the CombiMatrix group's liquidity and capital resources Management's Discussion and Analysis of Financial Condition and Results of Operations.

*The CombiMatrix group plans to raise additional capital through the sale of equity securities, and if the price of AR-CombiMatrix stock remains below \$1.00 per share, the dilution of existing stockholders could be greater than management initially anticipated.*

We expect to sell the maximum number of shares available under the standby equity distribution agreement with Cornell Capital in order to meet the capital requirements of the CombiMatrix group. To date, we have sold 3,211,345 shares out of a total of 13,024,924 shares available to be sold. In addition to selling 9,813,579 additional shares under the agreement with Cornell, we may need to issue a significant number of additional shares of AR-CombiMatrix stock to raise the additional capital the CombiMatrix group needs over the next 12 months. The dilution of existing holders of AR-CombiMatrix stock could be more than management initially anticipated if the stock price remains below \$1.00 per share.

*The recent decline in AR-CombiMatrix stock price could result in a goodwill impairment for the CombiMatrix group.*

Due to the recent decline in the AR-CombiMatrix stock, the CombiMatrix group's market value approximates its book value as of the date of this filing. Should the AR-CombiMatrix stock continue to decline below the CombiMatrix group's book value and if management concludes that the decline is other than temporary, the CombiMatrix group's goodwill could be impaired.

**Item 6. EXHIBITS**

- 10.1 Manufacturing and Supply Agreement with Furuno Electric Company, Ltd., effective July 1, 2006
- 31.1 Certifications of the Chief Executive Officer provided pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certifications of the Chief Financial Officer provided pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certifications of the Chief Executive Officer provided pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certifications of the Chief Financial Officer provided pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 99.1 Risk Factors incorporated by reference into Part II, Item 1A (1)

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(1) Incorporated by reference to Exhibit 99.1 of our Quarterly Report for the three months ended March 31, 2006.

**SIGNATURES**

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

ACACIA RESEARCH CORPORATION

By: /s/ Paul R. Ryan

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Paul R. Ryan  
Chief Executive Officer  
(Principal Executive Officer)

By: /s/ Clayton J. Haynes

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Clayton J. Haynes  
Chief Financial Officer / Treasurer  
(Principal Financial Officer)

Date: November 9, 2006



**EXHIBIT INDEX**

**EXHIBIT  
NUMBER EXHIBIT**

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(1) Incorporated by reference to Exhibit 99.1 of our Quarterly Report for the three months ended March 31, 2006.