

ENDOCARE INC  
Form 10-Q  
June 28, 2004

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**Form 10-Q**

(Mark One)

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

**For the Quarterly Period Ended September 30, 2003**

**or**

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

**For the Transition Period from        to        .**

**Commission file number: 000-27212**

**Endocare, Inc.**

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

**Delaware**  
*(State of Incorporation)*

**33-0618093**  
*(I.R.S. Employer I.D. No.)*

**201 Technology Drive, Irvine, California 92618**

*(Address of Principal Executive Office, Including Zip Code)*

**(949) 450-5400**

*(Registrant's Telephone Number, Including Area Code)*

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

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☒

The number of shares of the Registrant's common stock, par value \$.001 per share, outstanding at May 31, 2004 was 24,007,482.

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ENDOCARE, INC. AND SUBSIDIARIES

FORM 10-Q, QUARTER ENDED SEPTEMBER 30, 2003

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**EXPLANATORY NOTE:** We are filing this past due quarterly report on Form 10-Q for the quarter ended September 30, 2003 concurrently with our filing of past due quarterly reports on Form 10-Q for the quarters ended September 30, 2002, March 31, 2003 and June 30, 2003. Except as otherwise noted, this quarterly report on Form 10-Q speaks as of the date of filing. Accordingly, statements in this report on Form 10-Q containing the words (i) now, currently, present, to date, and words of similar import, or (ii) believes, intends, anticipates, expects, estimates, should, could, may, plans, planned, and words of similar import, are conditions existing on the date of filing of this quarterly report on Form 10-Q.

**PART I FINANCIAL INFORMATION****Item 1. Condensed Consolidated Financial Statements****ENDOCARE, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(Unaudited)

|                                                      | Three Months Ended<br>September 30, |                | Nine Months Ended<br>September 30, |                 |
|------------------------------------------------------|-------------------------------------|----------------|------------------------------------|-----------------|
|                                                      | 2003                                | 2002           | 2003                               | 2002            |
| Total revenues                                       | \$ 8,041,119                        | \$ 8,381,793   | \$ 23,193,270                      | \$ 23,807,706   |
| Costs and expenses:                                  |                                     |                |                                    |                 |
| Cost of revenues                                     | 4,093,747                           | 4,525,786      | 11,559,295                         | 12,018,692      |
| Research and development                             | 312,994                             | 489,890        | 1,011,244                          | 2,051,744       |
| Selling, general and administrative                  | 14,606,250                          | 8,408,328      | 36,133,116                         | 24,075,011      |
| Total costs and expenses                             | 19,012,991                          | 13,424,004     | 48,703,655                         | 38,145,447      |
| Loss from operations                                 | (10,971,872)                        | (5,042,211)    | (25,510,385)                       | (14,337,741)    |
| Gain on divestiture, net                             |                                     |                | 9,944,424                          |                 |
| Interest income                                      | 85,601                              | 317,314        | 524,926                            | 934,511         |
| Interest expense                                     | (6,870)                             |                | (34,168)                           |                 |
| Loss before minority interests                       | (10,893,141)                        | (4,724,897)    | (15,075,203)                       | (13,403,230)    |
| Minority interests                                   | (219,704)                           |                | (464,088)                          |                 |
| Net loss                                             | \$ (11,112,845)                     | \$ (4,724,897) | \$ (15,539,291)                    | \$ (13,403,230) |
| Net loss per share of common stock basic and diluted | \$ (.46)                            | \$ (.19)       | \$ (.64)                           | \$ (.57)        |
| Weighted average shares of common stock outstanding  | 24,182,004                          | 24,279,000     | 24,163,235                         | 23,695,667      |

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

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## ENDOCARE, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED BALANCE SHEETS

|                                                                                                                   | September 30,<br>2003 | December 31,<br>2002 |
|-------------------------------------------------------------------------------------------------------------------|-----------------------|----------------------|
|                                                                                                                   | (Unaudited)           |                      |
| <b>ASSETS</b>                                                                                                     |                       |                      |
| Current assets:                                                                                                   |                       |                      |
| Cash and cash equivalents                                                                                         | \$ 29,690,343         | \$ 18,177,825        |
| Available-for-sale securities                                                                                     |                       | 22,183,160           |
| Accounts receivable, net                                                                                          | 4,498,479             | 4,604,576            |
| Inventories                                                                                                       | 3,088,654             | 3,455,973            |
| Prepaid expenses and other current assets                                                                         | 6,984,774             | 640,758              |
| Assets held for sale                                                                                              | 1,343,692             | 3,800,517            |
|                                                                                                                   |                       |                      |
| Total current assets                                                                                              | 45,605,942            | 52,862,809           |
| Property and equipment, net                                                                                       | 6,720,465             | 8,229,288            |
| Goodwill                                                                                                          | 17,538,224            | 17,538,224           |
| Intangibles, net                                                                                                  | 12,046,811            | 13,013,880           |
| Investments and other assets                                                                                      | 2,244,763             | 983,754              |
|                                                                                                                   |                       |                      |
| Total assets                                                                                                      | \$ 84,156,205         | \$ 92,627,955        |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                                                       |                       |                      |
| Current liabilities:                                                                                              |                       |                      |
| Accounts payable                                                                                                  | \$ 3,967,780          | \$ 2,932,439         |
| Accrued compensation                                                                                              | 4,134,994             | 2,816,320            |
| Other accrued liabilities                                                                                         | 9,876,075             | 7,327,703            |
|                                                                                                                   |                       |                      |
| Total current liabilities                                                                                         | 17,978,849            | 13,076,462           |
| Minority interests                                                                                                | 955,479               | 928,741              |
| Commitments and contingencies                                                                                     |                       |                      |
| Stockholders' equity                                                                                              |                       |                      |
| Preferred stock, \$.001 par value; 1,000,000 shares authorized;<br>none issued and outstanding                    |                       |                      |
| Common stock, \$.001 par value; 50,000,000 shares authorized;<br>24,163,254 and 24,148,254 issued and outstanding | 24,365                | 24,350               |
| Additional paid-in capital                                                                                        | 171,830,037           | 169,935,487          |
| Accumulated deficit                                                                                               | (104,470,874)         | (88,931,583)         |
| Receivable from stockholder                                                                                       |                       | (214,292)            |
| Accumulated other comprehensive income, net of tax                                                                |                       | 12,466               |
| Deferred compensation                                                                                             | (90,020)              | (132,045)            |
| Treasury stock at cost, 201,200 shares                                                                            | (2,071,631)           | (2,071,631)          |
|                                                                                                                   |                       |                      |
| Total stockholders' equity                                                                                        | 65,221,877            | 78,622,752           |
|                                                                                                                   |                       |                      |
| Total liabilities and stockholders' equity                                                                        | \$ 84,156,205         | \$ 92,627,955        |

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



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## ENDOCARE, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

|                                                                                 | Nine Months Ended<br>September 30, |                |
|---------------------------------------------------------------------------------|------------------------------------|----------------|
|                                                                                 | 2003                               | 2002           |
| Net cash used in operating activities:                                          | \$(15,378,354)                     | \$(11,851,408) |
| Cash flows from investing activities:                                           |                                    |                |
| Acquisitions, net of cash acquired                                              |                                    | (24,092,497)   |
| Purchases of property and equipment                                             | (533,241)                          | (1,815,754)    |
| Intangibles                                                                     | (61,000)                           |                |
| Sales (purchases) of available-for-sale securities                              | 22,183,160                         | (20,183,303)   |
| Other assets                                                                    | (1,261,009)                        | (119,443)      |
| Net cash provided by (used in) investing activities                             | 19,890,560                         | (46,210,997)   |
| Cash flows from financing activities:                                           |                                    |                |
| Stock options and warrants exercised                                            | 20,312                             | 1,965,500      |
| Repurchase of treasury stock                                                    |                                    | (2,010,221)    |
| Partnership distributions to minority interests                                 | (437,350)                          |                |
| Proceeds from divestitures                                                      | 6,980,000                          |                |
| Net cash provided by (used in) financing activities                             | 7,000,312                          | (44,721)       |
| Net increase (decrease) in cash and cash equivalents                            | 11,512,518                         | (58,107,126)   |
| Cash and cash equivalents, beginning of period                                  | 18,177,825                         | 81,886,801     |
| Cash and cash equivalents, end of period                                        | \$ 29,690,343                      | \$ 23,779,675  |
| Non-cash activities:                                                            |                                    |                |
| Transfer of inventory to property and equipment for placement at customer sites | \$ 621,219                         | \$ 1,872,571   |
| Common stock issued and options assumed in the acquisition of Timm Medical      |                                    | 25,741,128     |
| Common stock issued for patents and covenant-not-to-compete                     |                                    | 3,257,139      |
| Change in unrealized gain (loss) on available-for-sale securities               | 12,466                             | 17,590         |

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

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**ENDOCARE, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**1. Organization and Operations of the Company**

Endocare, Inc. ( Endocare or the Company ) is a medical device company focused on developing, manufacturing and selling cryosurgical products with the potential to improve the treatment of cancer and other tumors. In addition, through its wholly-owned subsidiary, Timm Medical Technologies, Inc. ( Timm Medical ), the Company offers vacuum therapy systems for non-pharmaceutical treatment of erectile dysfunction. The Company was formed in 1990 as a research and development division of Medstone International, Inc., a manufacturer of shockwave lithotripsy equipment for the treatment of kidney stones. The Company was incorporated under the laws of the state of Delaware in 1994 and became an independent, publicly-owned corporation upon Medstone's distribution of the Company's stock to the existing stockholders on January 1, 1996.

Following the rules and regulations of the Securities and Exchange Commission (the SEC ), the Company has omitted footnote disclosures in this report that would substantially duplicate the disclosures contained in the Company's annual audited financial statements. The accompanying unaudited condensed consolidated financial statements should be read together with the consolidated financial statements and the notes thereto included in the Company's December 31, 2002 and 2003 Annual Reports on Form 10-K, filed with the SEC on December 3, 2003 and March 15, 2004, respectively.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and reflect all adjustments, consisting solely of normal recurring accruals, needed to present fairly the financial results for these interim periods. The condensed consolidated results of operations presented for the interim periods are not necessarily indicative of the results for a full year.

All intercompany transactions and accounts have been eliminated in consolidation.

**2. Recent Operating Results and Liquidity**

The Company's operating results for the nine months ended September 30, 2003 reflect the impact of divestitures of certain non-core lines of business. While these divestitures have allowed the Company to better concentrate on its core businesses, they have also eliminated some sources of revenue and gross profit for the Company going forward. In addition, while the Company lowered certain operating costs in 2003 by consolidating functions at its Irvine, California headquarters that were formerly performed by its subsidiaries, the Company has also incurred significant one-time charges associated with ongoing investigations related to its historical accounting and financial reporting. These costs have amounted to approximately \$20.2 million from the fourth quarter of 2002 through the first quarter of 2004 (including executive severance charges of \$3.2 million in the third quarter of 2003). Of these costs, \$10.9 million were incurred in the first three quarters of 2003 including the above-mentioned severance payments to former executives. In addition to charges for executive severance payments, these non-recurring expenses have included legal fees and settlements, audit fees and accounting support fees.

Since inception, the Company has incurred losses from operations and has reported negative cash flows. As of September 30, 2003, the Company had an accumulated deficit of \$104.5 million and cash and cash equivalents of \$29.7 million. As discussed above, commencing in the fourth quarter of 2002, the Company incurred, and continues to incur, significant additional costs in connection with internal and regulatory investigations into its historical accounting and financial reporting and has continued to incur operating losses. The Company also faces potentially large costs related to directors' and officers' liability insurance, delinquent state and local tax obligations, as well as additional expenditures needed to bring the Company into compliance with SEC rules and regulations, including with Section 404 of the Sarbanes-Oxley Act of 2002 and efforts to regain listing on a national exchange or market.

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**ENDOCARE, INC.**

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

There may also be material cash payments required in connection with resolving a class action and a derivative law suit (see Note 7). The Company may be required to pay judgments or settlements and to incur expenses in defending against these claims that could exceed the Company's directors' and officers' liability insurance coverage. Regulators may fine the Company when the investigations are complete.

The Company has continued to experience growth in probe and procedure revenues during the remainder of 2003 and into the first quarter of 2004. Costs and expenses have also grown through this period. Management intends to continue investment in sales and marketing to increase market penetration and in research and development to improve existing products and develop new ones. The Company will continue to use cash reserves, to finance its cash flow deficit. If the Company is unable to generate cash flows from operations, it may need to raise additional capital to fund operations through the sale of equity securities to public or private investors, debt or the sale or licensing of its assets. Additional capital, if needed, might not be available on terms acceptable to the Company, or at all. If additional capital were raised through the issuance of equity securities, the percentage of the Company's stock owned by its then-current stockholders would be reduced.

The Company has no long-term debt and no other material financial commitments other than those under operating lease agreements and purchase commitments for raw materials used in manufacturing its products.

**3. Stock-Based Compensation**

At September 30, 2003, Endocare had four stock-based compensation plans. The Company accounts for the plans under the recognition and measurement principles (the intrinsic-value method) prescribed in Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. Compensation cost for stock options granted to employees is reflected in net income (loss) and is measured as the excess of the market price of the Company's stock at the date of grant over the amount an employee must pay to acquire the stock, or the exercise price. Compensation costs for fixed awards that are subject to vesting is recognized pro-rata over the vesting period. In practice, the Company has only awarded stock options to its employees with exercise prices equal to the fair market value of the stock at the date of grant.

**Table of Contents****ENDOCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Company has adopted the disclosure provisions required by Statement of Financial Accounting Standard (SFAS) No. 148, *Accounting for Stock-Based Compensation Translation and Disclosure*. The following table illustrates the effect on net loss and loss per share if the Company had applied the fair value recognition provisions to stock-based employee compensation.

|                                                                                                                    | <b>Three Months Ended<br/>September 30,</b> |                | <b>Nine Months Ended<br/>September 30,</b> |                 |
|--------------------------------------------------------------------------------------------------------------------|---------------------------------------------|----------------|--------------------------------------------|-----------------|
|                                                                                                                    | <b>2003</b>                                 | <b>2002</b>    | <b>2003</b>                                | <b>2002</b>     |
| Net loss, as reported(a)                                                                                           | \$ (11,112,845)                             | \$ (4,724,897) | \$ (15,539,291)                            | \$ (13,403,230) |
| Reconciling items (net of related tax effects):                                                                    |                                             |                |                                            |                 |
| Add: Stock-based employee compensation expense determined under the intrinsic-value-based method for all awards(b) | 6,194                                       | 9,921          | 18,582                                     | 23,148          |
| Less: Stock-based compensation expense determined under the fair-value-based method for all awards expense(c)      | 873,196                                     | (1,203,209)    | (2,785,470)                                | (2,830,000)     |
| Net adjustment                                                                                                     | 879,390                                     | 1,193,288      | (2,766,888)                                | (2,806,852)     |
| Net loss, as adjusted                                                                                              | \$ (10,233,455)                             | \$ (5,918,185) | \$ (18,306,179)                            | \$ (16,210,082) |
| Basic and diluted loss per share:                                                                                  |                                             |                |                                            |                 |
| As reported                                                                                                        | \$ (.46)                                    | \$ (.19)       | \$ (.64)                                   | \$ (.57)        |
| As adjusted                                                                                                        | (.42)                                       | (.24)          | (.76)                                      | (.68)           |

- (a) The Company issues stock options and warrants to consultants for services performed. Compensation expense for the fair value of these instruments is determined by the Black-Scholes option pricing model and is charged to operations over the service period or as the performance goals are achieved. Such expense is included in net loss as reported. Stock-based compensation expense as reported for the 2003 periods includes a one-time charge of \$1,715,000 recorded in July 2003 for the fair value of 385,000 replacement options issued to the Company's former CFO on October 30, 2003 (see Note 7).
- (b) Since the Company issues options with exercise prices equal to or exceeding the fair values of the underlying common stock, no compensation expense is recorded for options issued to employees, except for compensation expense equal to the intrinsic value of unvested options assumed in the acquisition of Timm Medical and amortized over the remaining vesting period.
- (c) Pursuant to APB No. 25, the \$1,715,000 charge for the replacement options was recorded upon termination of the former CFO on July 31, 2003. Pursuant to SFAS No. 148, the fair value of these options would have been recorded prorata between the option modification date of March 3, 2003 and termination date, resulting in a net reduction in reported compensation expense for the quarter ended September 30, 2003.

**4. Goodwill and Intangible Assets**

The excess of the purchase price over the fair value of net assets acquired has been allocated to goodwill and identifiable intangible assets. The Company had no reported goodwill prior to January 1, 2002. The Company does not amortize goodwill, which is consistent with the

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provisions of SFAS No. 142, *Goodwill and other Intangible Assets*, but goodwill is subject to impairment tests on an annual basis or more frequently if

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impairment indicators exist. Under the guidance of SFAS No. 142, the Company uses a discounted cash flow methodology to assess the fair values of its reporting units. Impairment is measured by comparing the goodwill derived from the hypothetical purchase price allocation to the carrying value of the goodwill balance. No goodwill impairment indicators existed for the nine months ended September 30, 2003 and, as a result, interim impairment testing was not required.

Intangible assets that are deemed to have finite useful lives are recorded at cost and amortized using the straight-line method over their estimated useful lives. Estimated useful lives of such intangible assets are as follows:

|                         |               |
|-------------------------|---------------|
| Trade name              | 15 years      |
| Domain name             | 5 years       |
| Covenant-not-to-compete | 3 to 5 years  |
| Developed technology    | 15 years      |
| Patents                 | 3 to 15 years |

Changes in circumstances (for example, changes in laws or regulations to which the Company is subject, technological advances or changes in the Company's strategies) may result in changes to the useful lives from initial estimates. Factors such as changes in the planned use of intangibles may result from changes in customer base, contractual agreements, or regulatory requirements and may result in shorter useful lives. In such circumstances, the Company will revise the useful life of the long-lived asset and amortize the remaining net book value over the adjusted remaining useful life. There were no changes in estimated useful lives during 2002 and 2003.

**5. Acquisitions*****Timm Medical Technologies, Inc.***

On February 21, 2002, the Company entered into an agreement and plan of reorganization to acquire Timm Medical for total consideration of \$37,350,000, including \$838,000 in legal, accounting and other acquisition related costs. In connection with the merger, all outstanding shares of the capital stock of Timm Medical were exchanged for \$10,770,000 in cash and 1,620,530 shares of the Company's common stock valued at \$23,806,000 (of which 63,412 shares were held in escrow, which have now been released).

In addition, the Company assumed certain outstanding options of Timm Medical, which were exercisable into 168,162 shares of Endocare common stock at \$7.25 per share. These options were valued at \$1,935,000 using the Black-Scholes option pricing model, of which \$1,770,000 related to vested options and \$165,000 related to unvested options. Except for the adjustment in the number of exercisable shares and the corresponding exercise price per share based on the conversion ratio as defined in the purchase agreement, all other option terms and vesting periods remain unchanged. The value of the unvested options was recorded as deferred compensation on the acquisition date to be amortized over the remaining vesting period.

This transaction was accounted for under the purchase method of accounting and the consolidated financial statements of the Company include the financial results of Timm Medical from February 21, 2002 through subsequent periods. The total purchase price of \$37,350,000 (including transaction costs and the

**Table of Contents****ENDOCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

amount recorded as deferred compensation) was allocated to the tangible and intangible assets acquired based on their respective fair values as follows:

|                                                |               |
|------------------------------------------------|---------------|
| Total purchase consideration and related costs | \$ 37,350,000 |
| Fair value of tangible net assets acquired     | (1,041,000)   |
| Fair value of amortizable intangibles:         |               |
| Developed technology                           | (10,000,000)  |
| Trademark                                      | (500,000)     |
| Unearned compensation                          | (165,000)     |
|                                                | <hr/>         |
| Goodwill (non-tax deductible)                  | \$ 25,644,000 |
|                                                | <hr/>         |

Factors contributing to the origination of goodwill include the enhancement of the product line and projected growth in urology sales through collaborative distribution agreements with other medical device companies and the sales force which the Company believed would be valuable assets as the Company divested non-core product lines and redeployed existing resources in the area of cancer treatment. Intangible assets relating to developed technology and trade name are amortized over estimated useful lives of 15 years.

Net cash paid in the acquisition is as follows:

|                                                |               |
|------------------------------------------------|---------------|
| Total purchase consideration and related costs | \$ 37,350,000 |
| Fair value of common stock issued              | (23,806,000)  |
| Fair value of options assumed                  | (1,935,000)   |
|                                                | <hr/>         |
| Cash paid                                      | 11,609,000    |
| Cash acquired                                  | (1,127,000)   |
|                                                | <hr/>         |
| Net cash paid                                  | \$ 10,482,000 |
|                                                | <hr/>         |

Subsequent to the acquisition date, the Company decided to divest certain non-core product lines, including the Dura II penile implants line sold in April 2003, and the urinary incontinence and urodynamics lines sold in October 2003 (see Note 6).

***Mobile Prostate Treatment Businesses***

On September 30, 2002, the Company completed the acquisition of certain general and limited equity interests in the mobile prostate and benign prostatic hyperplasia ( BPH ) treatment businesses ( Mobile Prostate Treatment Businesses ) from a group of affiliated companies collectively known as USMD. Under the terms of the original agreement, the Company agreed to forgive \$7.7 million, consisting of a \$6.8 million loan and a \$900,000 earnest money deposit, if the Mobile Prostate Treatment Businesses achieved \$12 million in gross revenues during the period from October 1, 2002 to December 31, 2005 (the Forgiveness Period ). At the time of the acquisition, the Company assumed the loans would be forgiven and, therefore, included them in the total purchase consideration of \$11,734,000.

In February, 2004, the purchase agreement was amended to extend the Forgiveness Period to December 31, 2008. In addition, effective January 1, 2004, the Company reduced the service fee it pays to one of the partnerships for the use of their Cryocare Surgical Systems from \$2,500 to \$2,000 per procedure, representing an adjustment to a market rate. As a result, the reduction in service fee does not require a reallocation of goodwill.

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In late 2003 and early 2004, the Company initiated the dissolution of five of the 13 partnerships acquired from USMD, two of which were engaged in BPH treatment and three of which were engaged in cryosurgical procedures for prostate cancer (see Note 6).

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The total purchase price was allocated to the tangible and intangible assets acquired based on their respective fair value as follows:

|                                                                                |               |
|--------------------------------------------------------------------------------|---------------|
| Total purchase consideration (includes \$549,000 in acquisition related costs) | \$ 11,734,000 |
| Fair value of tangible net assets acquired (primarily property and equipment)  | (1,616,000)   |
| Covenant-not-to-compete                                                        | (240,000)     |
|                                                                                | <hr/>         |
| Goodwill (non-tax deductible)                                                  | \$ 9,878,000  |
|                                                                                | <hr/>         |

The goodwill is primarily related to the distribution network provided by the Mobile Prostate Treatment Businesses, which allows the Company to further penetrate desired markets. The tangible assets acquired include 11 Cryocare Surgical Systems previously purchased from the Company by USMD and resold to the partnerships. These systems were recorded at their fair value of \$2,109,000 on the acquisition date, which approximated the carrying value recorded by USMD, and are depreciated over their remaining useful lives not to exceed three years. The covenant-not-to-compete is amortized over three years.

Net cash paid in the acquisition is as follows:

|                                                |               |
|------------------------------------------------|---------------|
| Total purchase consideration and related costs | \$ 11,734,000 |
| Cash acquired                                  | (396,000)     |
|                                                | <hr/>         |
| Net cash paid                                  | \$ 11,338,000 |
|                                                | <hr/>         |

Endocare is the general partner or member in each of the Mobile Prostate Treatment Businesses and generally holds over 20% in combined general and limited equity interests. The Company has sole responsibility for the management of the Mobile Prostate Treatment Businesses and exercises exclusive control over their operations. Other equity holders have limited participation rights, which are protective in nature. As such, the Mobile Prostate Treatment Businesses have been consolidated with the Company's operations since September 30, 2002.

***Pro Forma Results of Operations***

The following table presents pro forma results of operations for the nine months ended September 30, 2002, assuming the Timm Medical and Mobile Prostate Treatment Business acquisitions occurred as of January 1, 2002:

|                                      |                |
|--------------------------------------|----------------|
| Revenues                             | \$ 26,097,000  |
|                                      | <hr/>          |
| Net loss                             | \$(15,191,000) |
|                                      | <hr/>          |
| Net loss per share basic and diluted | \$ (0.63)      |
|                                      | <hr/>          |
| Weighted average shares outstanding  | \$ 23,927,000  |
|                                      | <hr/>          |

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The pro forma results of operations reflect adjustments for additional amortization expense for intangible assets acquired, reduction in interest income due to net cash paid in acquisitions, stock compensation expense related to employee options assumed, and increased weighted average shares outstanding to reflect the issuance of common stock in the Timm Medical acquisition.

**Table of Contents****ENDOCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)*****Asset Purchases***

The Company has acquired intangible assets from time to time, including patents and intellectual property as follows:

On May 28, 2002, pursuant to an asset purchase agreement, the Company agreed to acquire the cryosurgical assets of Cryomedical Sciences, Inc., now known as BioLife Solutions, Inc. ( BioLife ), consisting primarily of a portfolio of patents, for \$2,200,000 in cash and 120,022 shares of the Company's common stock valued at \$1,847,000. This transaction was accounted for under the purchase method of accounting. The total purchase consideration of \$4,119,000 (including \$72,000 in acquisition-related costs) was allocated to the patents since other assets acquired had de minimis value. Pursuant to a Registration Rights Agreement, the Company was required to file a registration statement with the SEC to register the shares issued to BioLife. In November 2002, BioLife filed suit against the Company for failing to register the shares in a timely manner, seeking damages for breach of contract (see Note 7).

In February 2002, the Company entered into an asset purchase agreement with a cryosurgeon inventor of certain technologies related to the Company's business to acquire certain patents and a covenant-not-to-compete for 100,000 shares of the Company's common stock valued at \$1,410,000. Of this amount, \$1,058,000 (75,000 shares) was allocated to the patent and is amortized over 15 years and the remaining \$352,000 (25,000 shares) was allocated to the covenant-not-to-compete and is amortized over five years. The agreement also requires the seller to provide certain consulting services over 15 years for the consideration received. No consideration was allocated to the consulting agreement since the value of such services could not be accurately determined. In January 2003, the Company extended a \$344,000 loan to the seller to finance tax payments related to the gain on the sale (see Note 8).

**6. Dispositions and Restructuring Activities**

In 2003, the Company refocused its strategy on its core technological competence and primary market emphasis in the area of minimally invasive technologies for tissue and cancer ablation. Part of this strategy entailed divestiture of certain product lines unrelated to the Company's core businesses. The Company also undertook a review of its strategic plans and operational infrastructure in order to maximize efficiency and promote optimal use of resources. In addition to the divestiture of a Florida billing and contracting subsidiary in December 2002, which reduced headcount by 12 employees, in June 2003 the Company downsized Timm Medical's Eden Prairie, Minnesota, operations in June 2003, consolidating many administrative functions at the Company's Irvine, California, headquarters and reducing headcount by 26 employees. The Company's Board of Directors also approved the divestiture of certain non-core product lines and assets in the first quarter of 2003, including the sale of the Dura II penile implants, the cardiac-related product manufacturing operations and license of related technology, and the urinary incontinence and urodynamics product lines. These related assets were classified as held for sale at September 30, 2003. The corresponding balances at December 31, 2002 have also been reclassified as held for sale for comparative presentation.

Assets held for sale relating to the divested product lines include the following:

|                                         | <b>September 30,<br/>2003</b> | <b>December 31,<br/>2002</b> |
|-----------------------------------------|-------------------------------|------------------------------|
| Inventory                               | \$ 435,052                    | \$ 1,065,669                 |
| Property and equipment, net             | 14,197                        | 15,405                       |
| Intangibles, net (developed technology) | 894,443                       | 2,749,443                    |
|                                         | <u>\$ 1,343,692</u>           | <u>\$ 3,800,517</u>          |

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**ENDOCARE, INC.**

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

***Dura II Penile Implants***

On April 7, 2003, Timm Medical sold certain assets related to the Dura II positionable urological prostheses product line to American Medical Systems, Inc. for approximately \$2.15 million in cash. Assets sold include developed technology, intellectual property, customer lists, production equipment and Dura II inventory. The sale resulted in a loss of \$35,000 in the second quarter of 2003.

***Cryosurgical Products for Cardiac Applications***

On April 14, 2003, the Company sold its cardiac-related product manufacturing operations and licensed the related intellectual property to CryoCath Technologies, Inc. ( CryoCath ) for \$10 million and a nine-year descending royalty based on net sales of products incorporating the licensed technology. Upon consummation of the sale, the Company terminated its pre-existing distribution agreement with CryoCath. CryoCath was the exclusive distributor for cryoprobes and consoles in connection with the SurgiFrost system, a cryoablation system designed to treat cardiac arrhythmias. Since the technology was internally developed and the tangible assets sold had de minimus value, the sale resulted in a 2003 second quarter gain of \$10 million. The \$10 million was collected in four installments, three in 2003 and one in the first quarter of 2004. The royalty stream decreases from 10% to 3% of net sales from the SurgiFrost system during the period from 2004 to 2012. The first royalty payment of \$131,000 was collected and recorded in the first quarter of 2004, based on CryoCath revenues for that period.

***Minnesota Facility***

Subsequent to the acquisition of Timm Medical, the Company undertook a review of the Company's operational and financial infrastructure. To maximize operational efficiency and resource utilization, the Board of Directors approved a plan in the first quarter of 2003 to downsize Timm Medical's operations in Minnesota. With the exception of certain marketing and financial functions, all of Timm Medical's operations were transferred to the Company's Irvine, California, headquarters in June 2003 or were outsourced. The cost of the restructuring totaled \$386,000, which included \$266,000 in severance payments and \$120,000 in lease losses for vacating the unused leased space. These losses were recorded in the second quarter of 2003 upon the communication of the separation terms to the affected employees. In addition, Timm Medical had \$465,000 in property and equipment, a portion of which may be abandoned or sold for salvage value at a future date. These assets are classified as held and used until they are disposed or abandoned. In the first quarter of 2003, management had adjusted the useful life of the assets to be abandoned to amortize their carrying value, less estimated salvage, through the scheduled abandonment date of April 2004.

***Urinary Incontinence and Urodynamics***

On October 15, 2003, Timm Medical agreed to sell the manufacturing assets related to its urodynamics and urinary incontinence product lines to SRS Medical Corp. ( SRS ) for a \$2,694,000 note. The note bears interest at 7.5% and is secured by the assets sold, which consist of certain patents, trademarks, inventory, customer lists and technical know-how. Under the terms of the original agreement, quarterly payments were to begin on March 31, 2004, equal to the higher of (a) minimum quarterly payments as defined or (b) 15% of the net revenues related to the urinary incontinence assets acquired and 15% of the net revenues related to SRS's existing urodynamics business, including the urodynamics assets acquired. These minimum quarterly payments were to commence at \$112,500 for the quarter ended March 31, 2004, and increase to \$298,406 for the quarter ended March 31, 2007. Amounts which remain outstanding at March 31, 2007 were to be payable at \$250,000 per quarter thereafter until fully paid. The carrying values of the urodynamics and urinary incontinence related assets were \$1,314,000 on the date of sale. Management concluded that collection of the note from SRS was not reasonably assured. As a result, a loss of \$1,314,000 was recorded in the fourth quarter of 2003 equal to the carrying value of the assets sold. Collections on the note, if any, will be reported as gain in

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**ENDOCARE, INC.**

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

the period received. In March 2004, the Company agreed to amend the purchase agreement to reduce the minimum quarterly payments to \$45,000, increasing to \$60,000 for the quarter ended December 31, 2005. Amounts which remain outstanding at December 31, 2005 will be payable at \$60,000 per quarter until the outstanding principal and accrued interest are paid in full.

***Mobile Prostate Treatment Businesses***

In late 2003 and early 2004, the Company initiated the dissolution of five of the 13 partnerships acquired from USMD, two of which were engaged in BPH treatment and three of which were engaged in cryosurgical procedures for prostate cancer. The BPH partnerships discontinued operations beginning in the first quarter of 2003 due to significant reduction in payor reimbursements and the Company's desire to exit the non-core BPH business. The Company elected to terminate the cryosurgical partnerships due to decisions by certain of the limited partner physicians to withdraw from these partnerships. After the dissolution, the Cryocare Surgical Systems held by these partnerships were redeployed to other markets as placement units. The assets held by the BPH partnerships will be liquidated.

**7. Commitments and Contingencies**

***Former Chief Executive Officer and Chairman of the Board***

The Company entered into a Separation Agreement and a one-year Consulting Agreement with the Company's former Chief Executive Officer and Chairman of the Board (the former CEO), each effective as of July 31, 2003. Under the Separation Agreement, the former CEO was entitled to receive a \$375,000 severance payment and a \$375,000 upfront payment for a one-year covenant-not-to-compete and an agreement to provide consulting services. The Company recorded a charge of \$775,500 in the third quarter of 2003 for the severance and related benefits. The total severance payment was deposited into an escrow account held by the Company and released to the former CEO in March 2004.

***Former Chief Financial Officer***

The Company entered into an employment agreement, dated March 3, 2003 (the Employment Agreement), with the Company's former Chief Financial Officer (former CFO). Under the Employment Agreement, upon any Qualified Termination (as defined) the former CFO was entitled to receive a cash payment of \$616,000, continued participation in the Company's benefit plans for 24 months, a \$50,000 relocation allowance and an additional payment to cover the tax liabilities relating to the allowance. In addition, the Employment Agreement also provided that all of the former CFO's options to purchase outstanding common stock (385,000 shares) would be cancelled and replaced by immediately exercisable options to be granted between September 4, 2003 and November 3, 2003. Effective July 31, 2003, the Company terminated the former CFO's employment other than for cause. The Company recorded a charge of \$731,000 in the third quarter of 2003 for the severance and related benefits due under the Employment Agreement. In addition, the Company recorded a third quarter charge for \$1,715,000 for the fair value of the 385,000 replacement options issued to the former CFO on October 30, 2003 determined using the Black-Scholes option-pricing model. The total severance payments due of \$616,000 were deposited into an escrow account held by the Company. In March 2004, all amounts due to the former CFO under the Employment Agreement were released from the escrow account.

***2002 Executive Separation Benefits Plan***

Effective July 17, 2002, the Company adopted the 2002 Executive Separation Benefits Plan (Separation Plan) to provide separation benefits to certain designated employees upon or following a change in control, as defined. In February 2004, the Board of Directors voted to terminate the Separation Plan effective July 18, 2004. On February 13, 2004, Craig T. Davenport (Chairman and Chief Executive Officer), William J. Nydam

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**ENDOCARE, INC.**

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

(President and Chief Operating Officer) and Katherine Greenberg (Chief Financial Officer) were added as Eligible Employees as defined in the Separation Plan.

***Legal Matters***

The Company is a party to lawsuits in the normal course of its business. Litigation and governmental investigation can be expensive and disruptive to normal business operations. Moreover, the results of complex legal proceedings are difficult to predict. The Company can provide no assurance that significant judgments or settlements in connection with the legal proceedings described below will not have a material adverse effect on the Company's business, financial condition, results of operations and cash flows. (See Part I, Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations and Part II, Item 1 Legal Proceedings.) Other than as described below, the Company is not a party to any material legal proceedings.

In November 2002, the Company was named as a defendant, together with certain former officers, one of whom is also a former board member, in a class-action lawsuit filed in the United States District Court for the Central District of California. On February 2, 2003, the court issued an order consolidating this action with various other similar complaints and ordering plaintiffs to file a consolidated complaint, which was filed on October 31, 2003. The consolidated complaint asserts two claims for relief, alleging that the defendants violated sections of the Securities Exchange Act of 1934 by purportedly issuing false and misleading statements regarding the Company's revenues and expenses in press releases and SEC filings. Plaintiffs seek class certification and unspecified damages from the Company, as well as forfeiture and reimbursement of bonus compensation received by two of the individual defendants. On April 26, 2004, the court issued an order denying the Company's motion to dismiss the consolidated complaint. The Company intends to defend the case vigorously, but cannot assure you that it will be resolved in the Company's favor.

On November 26, 2002, BioLife Solutions, Inc. (BioLife) filed an action against the Company in the Delaware Court of Chancery seeking damages for alleged breaches of contract stemming from the Company's acquisition, pursuant to an asset purchase agreement dated May 28, 2002, of the tangible and intangible assets related to BioLife's cryosurgical business. In the action, styled as BioLife Solutions, Inc. v. Endocare, Inc., Del. Ch., C.A. No. 20057-NC, BioLife alleged that the Company failed to timely register 120,022 shares of its common stock that were provided to BioLife in connection with the asset purchase agreement, in violation of a registration rights agreement relating to the shares that was executed in conjunction with the asset purchase agreement. BioLife sought damages of approximately \$1.6 million. The Company defended the action on the grounds that its obligation to register the shares was excused for various reasons, including as a consequence of BioLife's failure to transfer assets in accordance with the asset purchase agreement. Trial on all but one of the claims in the action was held during the week of March 31, 2003. On October 1, 2003, the Delaware Court ruled in favor of BioLife, awarding BioLife \$1,648,000, plus pre-judgment interest and costs (including legal fees), and requiring BioLife to surrender the 120,022 shares of the Company's common stock to the Company. That ruling became an appealable final order and judgment on October 10, 2003. On February 20, 2004, the Company agreed with BioLife to settle all claims. As part of the settlement the Company paid to BioLife \$1,887,000, which represented a discount of \$150,000 from the total judgment amount (including accrued interest and costs), BioLife returned to the Company the 120,022 shares of the Company's common stock referred to above and the Company agreed to abandon its appeal.

On December 6, 2002, Frederick Venables filed a purported derivative action against the Company and certain former officers and certain current and former board members in the California Superior Court for the County of Orange alleging breach of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets and unjust enrichment. On April 23, 2004, the parties filed a stipulation agreeing to a conditional stay of the action for 270 days, continuing the deadline to respond to the complaint until after expiration of the stay. The complaint seeks unspecified monetary damages, equitable relief and injunctive

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**ENDOCARE, INC.**

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

relief based upon allegations that the defendants issued false and misleading statements regarding the Company's revenues and expenses in press releases and SEC filings. The Company intends to defend the case vigorously, but cannot assure you that it will be resolved in the Company's favor.

The SEC is currently conducting an investigation to determine whether any federal securities laws were violated in connection with the filing of the Company's financial statements for 2001 and the first two quarters of 2002, including investigation into allegations that the Company and certain of the Company's current and former officers and directors issued or caused to be issued false and misleading statements regarding the Company's revenues and expenses in those SEC filings. The Company is cooperating fully with this investigation. The Company cannot assure you that this matter will be resolved in its favor.

The Department of Justice (DOJ) is currently conducting an investigation into allegations that the Company and certain of its current and former officers and directors intentionally issued or caused to be issued false and misleading statements regarding the Company's revenues and expenses in SEC filings. The Company is cooperating fully with this investigation. The Company cannot assure you that this matter will be resolved in its favor.

In December 2002, the Company filed a demand for arbitration before the American Arbitration Association in Minnesota against a former employee. The complaint included various claims in response to which the employee made several counterclaims. In March 2003, the Company was notified by the United States Department of Labor that counsel for the employee had presented a letter of complaint alleging that the Company, its former CEO and former CFO violated 18 U.S.C. § 1514A by improperly retaliating against the employee. In December 2003, the Company and the employee agreed to settle all claims on mutually acceptable terms without the admission of liability by any party for an amount that is not significant. Pursuant to the settlement, the employee withdrew his letter of complaint, and the Department of Labor has indicated that it considers the matter closed.

In June 2003, the Company was awarded a favorable judgment for \$351,000 in a litigation matter previously initiated by Timm Medical against a third party. Since collection is not assured, any amount recovered in connection with this judgment will be recorded in the period when it is actually paid to the Company.

**8. Related Party Transactions**

***Loans to Officers***

In November 1999, the Company received a full recourse promissory note for \$1,028,125 in connection with the sale of 175,000 common shares at fair value to the Company's then-Senior Vice President, Sales and Marketing. The four-year note bore interest at 5.99% per annum, payable annually, and was recorded as a reduction in stockholders' equity. The Company agreed to forgive the principal on the note ratably over four years subject to performance of certain objectives that were to be mutually agreed upon by the borrower and the Company and subject to the borrower remaining an employee of the Company. The Company forgave \$85,792 and \$64,250 for the three months ended September 30, 2003 and 2002, respectively, which was recorded as compensation expense (included in selling, general and administrative expense). As of September 30, 2003, the full value of the note had been written off.

In January 2003, the Company extended a \$344,000 non-recourse loan to an individual who is a shareholder and consultant. The Company previously entered into an asset purchase agreement with the shareholder in February 2002 to acquire certain patents and a covenant-not-to-compete. The Company extended the loan to the shareholder to assist with the payment of federal income taxes arising from the 2002 purchase transaction. The loan is secured by the shares issued, bears interest at 1.8% and is due at the earlier of January 2005 or 30 days after the borrower ceases to be a consultant to the Company (see Note 5).

**Table of Contents****ENDOCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****9. Capital Stock and Earnings Per Share**

Basic earnings (loss) per share are computed by dividing net income (loss) by the weighted average number of common shares outstanding for the respective periods. Diluted earnings (loss) per share, calculated using the treasury stock method, gives effect to the potential dilution that could occur upon the exercise of certain stock options and warrants that were outstanding during the respective periods presented. Since the Company reported a net loss for the three months and nine months ended September 30, 2003 and 2002, these potentially dilutive common shares were excluded from the diluted loss per share calculation.

|                                           | <b>Three Months Ended<br/>September 30,</b> |                | <b>Nine Months Ended<br/>September 30,</b> |                 |
|-------------------------------------------|---------------------------------------------|----------------|--------------------------------------------|-----------------|
|                                           | <b>2003</b>                                 | <b>2002</b>    | <b>2003</b>                                | <b>2002</b>     |
| Net (loss)                                | \$ (11,112,845)                             | \$ (4,724,897) | \$ (15,539,291)                            | \$ (13,403,230) |
| Basic and diluted loss per common share   | \$ (.46)                                    | \$ (0.19)      | \$ (0.64)                                  | \$ (0.57)       |
| Basic and diluted weighted average shares | 24,182,004                                  | 24,279,000     | 24,163,235                                 | 23,695,667      |

**10. Income Taxes**

The Company reported no income tax expense for each of the nine months ended September 30, 2003 and 2002 due to its operating losses. The continuing operating losses resulted in an increase in the valuation allowance of \$6.2 million and \$5.4 million during the nine months ended September 30, 2003 and 2002, respectively. Due to the Company's history of operating losses, management cannot conclude that the Company's deferred tax asset will be realized through future earnings. Accordingly, valuation allowances were recorded to fully reserve the Company's deferred tax assets as of September 30, 2003 and 2002.

**11. Subsequent Events**

During the first quarter ended March 31, 2004, the Company retired 326,222 of its common shares held in treasury, including 120,022 shares re-purchased from BioLife for \$503,729 in February 2004 in connection with the settlement of its litigation with this company.

Through its acquisition of Timm Medical in February 2002, the Company obtained offices, manufacturing and research facilities for its erectile dysfunction products in a 28,066 square foot building in Eden Prairie, Minnesota. This lease expired on April 30, 2004. Due to the net downsizing of its Minnesota operations and divestiture of several product lines acquired in the purchase of Timm Medical, the Company decided not to renew its existing lease and instead negotiated a lease for a smaller facility. In May 2004, the Company agreed to enter into a new lease on 8,919 square feet in the existing facility to house its Minnesota operations. The monthly rental payment during the term of the lease will range from \$0.61 to \$0.67 per square foot, excluding common area maintenance costs. The aggregate rental obligation over the term of the lease will be approximately \$343,000. The lease for this office and warehouse facility expires in 2009.

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

*The following discussion and analysis should be read in conjunction with the unaudited condensed consolidated financial statements and notes thereto included in Part I Item 1 of this report, and the audited consolidated financial statements, and notes thereto, and Management's Discussion and Analysis of Financial Condition and Results of Operations contained in the Annual Reports on Form 10-K for the fiscal years ended December 31, 2003 and 2002.*

*This discussion contains forward-looking statements based on our current expectations. There are various factors—many beyond our control—that could cause our actual results or the occurrence or timing of expected events to differ materially from those anticipated in these forward-looking statements. Some of these factors are described below and other factors are described elsewhere in this Quarterly Report on Form 10-Q. In addition, there are factors not described in this Quarterly Report on Form 10-Q that could cause our actual results or the occurrence or timing of expected events to differ materially from those anticipated in these forward-looking statements. All forward-looking statements included in this Quarterly Report on Form 10-Q are based on information available to us as of the date hereof, and we assume no obligation to update any such forward-looking statements.*

#### **Overview**

We are a medical device company focused on developing, manufacturing and selling cryosurgical products with the potential to improve the treatment of cancer and other tumors and on manufacturing and marketing vacuum technology as a non-pharmacological option for treatment of erectile dysfunction. Our cryosurgical products include a computerized device (the Cryocare Surgical System), and disposable cryoprobes and temperature probes used to safely and effectively freeze cancerous tissue or other tumors through our proprietary argon gas-based technology. We recently introduced the next generation of our Cryocare Surgical System, the Cryocare CS. Our erectile dysfunction products, sold through our wholly-owned subsidiary, Timm Medical, include the ErecAid Esteem and the ErecAid Classic for treatment of impotence as well as the RigiScan for diagnostic evaluation of this condition.

Currently, our cryosurgical products are sold chiefly to hospitals for the treatment of prostate cancer. In addition, we are exploring the application of our cryosurgical technologies for ablation of other tumors, specifically in the treatment of tumors of the kidney, lung, and liver and for pain management related to metastatic bone cancer. We sell our vacuum therapy products for treatment of erectile dysfunction primarily to individual patients on a prescription basis. Our RigiScan products are sold to physicians.

We have incurred significant operating losses and negative cash flows from operations in each full fiscal year since January 1, 1996. We incurred a net loss of \$15.5 million for the nine months ended September 30, 2003 and a loss of \$42.0 million for the year ended December 31, 2002. As of September 30, 2003, we had an accumulated deficit of \$104.5 million. We expect to incur additional losses as we expand our sales and marketing efforts, strengthen our infrastructure, improve our financial reporting processes and controls and continue to develop new products.

In addition to the cash needed to fund our ongoing operations, there have been and will continue to be substantial demands on cash in connection with ongoing investigations by the SEC and the DOJ of our historical accounting and financial reporting and related matters, including restatements of our consolidated financial statements filed in the Company's Annual Reports on Form 10-K for the years 2000 and 2001 and in our Quarterly Reports on Form 10-Q for the first and second quarters of 2002, as well as expenses related to shareholder litigation. (See Notes 1 and 2 to the condensed consolidated financial statements included in this report.)

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**Results of Operations**

***Three and Nine Months Ended September 30, 2003 Compared to Three and Nine Months Ended September 30, 2002***

Among the major factors contributing to the fluctuation of our operating results for the nine months and the quarter ended September 30, 2003, compared to the same periods in 2002 were acquisitions of two significant businesses in 2002 and the divestitures of two product lines in the second quarter of 2003. Timm Medical was purchased on February 1, 2002 and the mobile prostate treatment businesses previously owned by USMD were purchased on September 30, 2002. Each of these acquisitions brought additional sales as well as additional costs. (See Notes 5 and 6 to the unaudited condensed consolidated financial statements.)

Another factor affecting our results included a decision by our new management to concentrate our marketing efforts in areas related to our core technologies cryoablation of tumors and vacuum therapy for treatment of erectile dysfunction. This decision resulted in the winding down of research and development activities associated with the Horizon Prostatic Stent and the SurgiFrost product line. Additionally, we embarked on a strategy aimed at divesting several non-core product lines. These divestitures occurring during the second and forth quarter of 2003 and include sales of assets and licensing of the intellectual property and manufacturing rights associated with the SurgiFrost product used in treatment of cardiac arrhythmia as well as the Dura II penile prosthesis and the urinary incontinence products acquired in the Timm Medical purchase.

Finally, results in the third quarter of 2003 continued to be impacted by ongoing internal and regulatory investigations into our historical accounting and financial reporting and the resulting distraction of both management and sales personnel. In addition, negative publicity associated with these investigations, the fall in our stock price and the delisting of our stock from Nasdaq on January 16, 2003, all contributed to uncertainty among our customers regarding the viability of our business. Also as a result of these investigations, we have incurred significant legal and other costs related to addressing matters stemming from the investigations, including the need to appoint new independent auditors and a new Chief Executive Officer, President and Chief Financial Officer.

**Revenues.** We generate revenues from sales of our Cryocare Surgical Systems, disposable cryoprobes and other disposable devices used in cryoablation procedures. We also contract with hospitals and other health care payors for the use of our Cryocare Surgical Systems in cryoablation treatments for which we charge a per-procedure fee.

Beginning with the first quarter of 2003, we shifted our sales emphasis for cryosurgical products in the urology market from equipment sales to procedure growth. Through our placement program, we provide equipment to hospitals with high-volume potential for cryosurgery procedures and charge them a per-procedure fee for use of the equipment.

The procedure fee typically includes a procedure kit containing cryoprobes and other disposables needed to perform a cryosurgical procedure, in addition to a service component. The service component of the procedure fee generally consists of rental and transport of a Cryocare Surgical System as well as the services of a technician to assist the physician with the set-up, use and monitoring of the equipment. In certain instances, we will provide the service component of the procedure to the hospital as well as the devices. At other times, we will contract with a third party to perform the service component of the procedure and will remit a service fee to the third party upon invoicing the hospital. We also sell just the disposable devices to hospitals, without the service component, where the hospital either owns the equipment or independently contracts with a service provider.

In addition to our cryosurgery products, we sell other urological products acquired when we purchased Timm Medical, a urological device manufacturer, in February 2002. We continue to sell our ErecAid vacuum therapy systems and RigiScan monitors, although in 2003 we either divested or discontinued the remaining product lines acquired in the Timm Medical purchase. The reduction in year-over-year sales of our Timm Medical urology products is primarily attributable to these divestitures. Sales of subsequently divested or discontinued product lines acquired in the Timm Medical purchase totaled \$287,000 and \$1,589,000

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respectively, for the three and nine months ended September 30, 2003 compared to \$1,060,000 and \$2,673,000 for the same periods in 2002, respectively.

A portion of our revenue also comes from sales of the SurgiFrost cryosurgical line, which we developed for treatment of cardiac arrhythmia. In 2002 and through the first quarter of 2003, we sold these products to CryoCath under the terms of a distribution agreement. In April 2003, we licensed to CryoCath the manufacturing and intellectual property rights to these products and sold them related assets. Beginning with the first quarter of 2004, we became entitled to royalty income based on CryoCath's continued sales of these products. (See Note 6 to our condensed consolidated financial statements.) Sales to CryoCath totaled \$1,061,000 for the three months ended September 30, 2002. There were no sales to CryoCath in the third quarter of 2003.

Revenues for the three months ended September 30, 2003 decreased 4.1% to \$8,041,000 compared to \$8,382,000 for the three months ended September 30, 2002. The reduction in revenues was partly attributable to lower sales of products we acquired in the purchase of Timm Medical. Third quarter sales of our Timm Medical products were down \$1,282,000 compared to the same period in 2002, partly due to the divestiture of the Dura II line of implantable penile prosthesis. Sales to CryoCath also decreased \$1,061,000 due to our divestiture of the SurgiFrost product line. In addition, following our acquisition of Timm Medical, sales personnel who came to the Company through the Timm Medical purchase were trained to sell our cryosurgical products. In many cases, they became responsible for both product lines. This served to dilute their efforts and resulted in lower revenues of our Timm Medical products.

The reduction in revenues was partially offset by a \$1,606,000 increase in sales of our disposable cryoprobes and procedures reflecting an increase in the number of procedures performed to 964 cases in the third quarter of 2003 from 665 in the third quarter of 2002. In addition, in the third quarter of 2003, we collected \$450,000 in cash payments related to sales of our Cryocare Surgical System that were reversed in the restatement of our consolidated financial statements due to uncertainty regarding the customer's intent or ability to pay for the equipment. This enabled us to book the \$450,000 as revenue in the period we collected the receivable.

Revenues for the nine months ended September 30, 2003 decreased 2.6% to \$23,193,000 compared to \$23,808,000 during the same period in 2002. Divestitures of the SurgiFrost and the Dura II lines, as well as the cross training of our sales personnel, as mentioned above, contributed to the lower sales performance for the first nine months of 2003 compared to the first nine months of 2002. Sales of our Timm Medical products declined by \$923,000 for the nine months ended September 30, 2003 compared to the earlier period. Sales of our SurgiFrost product also decreased \$1,239,000 to \$351,000 in the nine months ended September 30, 2003 from \$1,590,000 in the 2002 period.

Sales also decreased by \$2,263,000 due to the sale of fewer Cryocare Surgical Systems. We sold 20 Cryocare Surgical Systems in the first nine months of 2002 compared to 10 units in the first nine months of 2003. Offsetting the reduction in 2003 equipment sales was \$781,000 in revenues recovered for Cryocare Surgical Systems sold during and prior to 2002 for which revenues were reversed or deferred in the restatement of our consolidated financial statements.

These revenue reductions were also partially offset by an increase in sales of disposables and procedure fees related to our cryosurgical business. A total of 2,514 procedures was performed in the first three quarters of 2003 compared to 1,584 during the same period in the prior year. Sales of these products were up by \$2,714,000 for the nine months ended September 30, 2003 compared to the nine months ended September 30, 2002.

*Cost of Revenues.* Cost of revenues consists of fixed and variable costs incurred in the manufacture of our products in addition to depreciation of Cryocare Surgical Systems placed in the field with customers, or with our sales and service personnel, under our placement program. We incur an additional cost of revenues in the form of a fee for equipment usage and other services when a procedure is performed on a Cryocare Surgical System owned by an unrelated service provider. That portion of the procedure fee remitted to the third-party service provider is charged to cost of revenues when the procedure is performed and billed. We

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retain a larger profit on procedures performed on systems owned by us where no outside service fees are incurred. In addition, we have incurred charges for product warranties as well as excess and obsolete inventory, shrinkage and other inventory carrying costs. Also included in cost of revenues are costs of maintaining patents or other intellectual property rights to processes or technologies related to our products, royalties on product sales and amortization of developed technology acquired in connection with our acquisition of Timm Medical.

Cost of revenues for the three months ended September 30, 2003 decreased 9.5% to \$4,094,000 compared to \$4,526,000 for the three months ended September 30, 2002. Divestiture of both the Dura II line acquired from Timm Medical and the SurgiFrost line sold to CryoCath account for a portion of the reduction in cost of revenues. The reduction in sales of Cryocare Surgical Systems in 2003 compared to 2002 also contributed to a lower cost of revenues in the 2003 quarter. These reductions in cost of revenues were partially offset by growth in sales of cryosurgical probes and procedure fees as discussed above. Also offsetting the decline in capital equipment sales was the increase in payments of procedure fees to third party cryosurgical service providers.

Cost of revenues for the nine months ended September 30, 2003 decreased 3.8% to \$11,559,000 compared to \$12,019,000 in 2002. The drop in cost of revenues was partially due to divestiture of product lines and reduction in capital equipment sales, as discussed above. Another reason for the lower cost of revenues for the nine-month period in 2003 was the absence of cost of revenues related to sales of Cryocare Surgical Systems that were reversed in the first three quarters of 2002. Cost of revenues in the nine months ended September 30, 2002 included 16 Cryocare Surgical Systems for which revenues were originally reported in 2002 but were reversed in the restatements of our consolidated financial statements. In the third quarter of 2002, we shipped five systems to customers for which we recorded cost of sales but did not recognize revenue. Due to the fact that our customers retained possession of these systems, we did not reverse the related cost of revenues.

*Gross Margins.* Gross margins on revenues increased to 49.1% for the three months ended September 30, 2003 compared to 46.0% for the three months ended September 30, 2002. The principal reason for the margin improvement in the third quarter of 2003 compared to the same period in 2002 was the absence of cost of revenues related to Cryocare Surgical Systems shipped to customers in 2002 for which we could not recognize revenue, as discussed in above. Partly offsetting the impact of revenue reversals on equipment sales were changes in product mix resulting from divestitures of higher margin products and an increase in the percentage of our cryosurgical procedures serviced by third parties to whom we pay a service fee. Gross margins in the third quarter of 2003 were also favorably impacted by \$450,000 in revenues recovered for units sold in 2002 and prior.

Gross margins on revenues for the nine months ended September 30, 2003 increased to 50.2% compared to 49.5% for the same period in 2002. While the absence of reversed system sales and recoveries of revenues for systems sold in prior years favorably impacted the nine month period in 2003, the increase in payments of procedure fees to third parties put downward pressure on our gross margins.

*Research and Development Expenses.* Research and development expenses include expenses associated with the design and development of new products as well as significant enhancements to existing products. These expenses consist primarily of salaries and related benefits and overhead costs for staff engaged in research and development activities, costs for materials and supplies used in performing research and development activities, costs of clinical trials conducted for the purpose of obtaining regulatory approval of our products, consulting and advisory fees for outside service providers directly involved in research and development activities, and depreciation on equipment used directly for research and development activities. We expense research and development expenses when incurred. Our research and development efforts are periodically subject to significant non-recurring expenses and fees that can cause some variability in our quarterly research and development expenses.

Research and development expenses for the three months ended September 30, 2003 decreased 36.1% to \$313,000 compared to \$490,000 for the three months ended September 30, 2002. The decrease was primarily attributable to our discontinuing development of the Horizon Prostatic Stent and the ThermoStent for treatment of BPH. In addition we discontinued formerly significant research and development activities associated with our SurgiFrost cardiac products prior to the sale and licensing of these products to CryoCath

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in April 2003. Research and development expenses in 2003 were primarily related to the design, development, and testing of our new CS System for the prostate cancer market. As a percentage of revenues, research and development expenses decreased from 5.8% in the year 2002 to 3.9% during the three months ended September 30, 2003.

Research and development expense for the nine months ended September 30, 2003 decreased 50.7% to \$1,011,000 compared to \$2,052,000 for the same period in 2002. As a percentage of revenues, research and development expenses decreased from 8.6% to 4.4%. The variances are attributable to the reasons stated above.

*Selling, General and Administrative Expenses.* Selling, general and administrative expenses primarily consist of salaries, commissions and related benefits and other overhead costs for employees and activities in the areas of sales, marketing, customer service, clinical services, finance, information technology, human resources and administration. Fees for attorneys, independent auditors and certain other outside consultants and suppliers are included where their services or products are related to selling, general and administrative activities. Costs of insurance premiums, including for directors and officers liability and products liability coverage, are also included in this category. Expenses associated with advertising, trade shows, promotional and training costs related to marketing our products are also classified as selling, general and administrative expenses as are the costs of conducting clinical research studies for the purpose of collecting clinical data used in promoting our products.

Selling, general and administrative expenses for the three months ended September 30, 2003 increased 73.7% to \$14,606,000 compared to \$8,408,000 for the three months ended September 30, 2002. As a percentage of revenues, selling, general and administrative expenses were 181.6% and 100.3% for the third quarters of 2003 and 2002, respectively.

Approximately \$7.5 million of the cost increase in selling, general and administrative expenses is related to investigations by our audit committee, the SEC and the DOJ into possible accounting irregularities, including related legal fees and settlements and audit expenses and severance payments to former executives. Of this amount, approximately \$3.2 million represents severance-related payments made to our former CEO and CFO, which included a \$1.7 million non-cash charge taken for issuing 385,000 options to our former CFO following his separation.

The 2003 costs for the urological portion of our business included a full nine months of operations while 2002 represented seven months of expenses following the February 2002 acquisition of Timm Medical.

Partially offsetting these non-recurring costs were some savings in general and administrative costs resulting from consolidation of certain administrative functions, formerly performed at our subsidiary locations in Eden Prairie, MN and Winter Park, FL, at our Irvine, CA headquarters. In addition, we significantly downsized our Timm Medical operations in Eden Prairie and closed our office in Winter Park. As a result of consolidating these operations, we were able to reduce headcount by 18%, from 196 employees at September 30, 2002 to 161 at September 30, 2003.

Selling, general and administrative expenses for the nine months ended September 30, 2003 increased 50.0% to \$36,113,000 compared to \$24,075,000 for the same period in 2002. The increase is primarily attributable to the non-recurring costs related to investigations into our historical accounting and financial reporting, offset by some cost savings in our operations as discussed above.

*Interest Income, Net.* Interest income, net for the three months ended September 30, 2003 was \$79,000 compared to \$317,000 for the three months ended September 30, 2002. The drop in net interest income in 2003 compared to 2002 resulted from declining cash balances throughout 2003 combined with lower interest rates.

Interest income, net for the nine months ended September 30, 2003 was \$491,000 compared to \$935,000 for the nine months ended September 30, 2002. The reduction was primarily due to reasons stated above.

*Minority Interests.* Minority interests represent earnings attributable to minority investors in the mobile prostate treatment businesses we acquired from USMD on September 30, 2002. The amount recorded for

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minority interests was \$220,000 and \$464,000 for the three months and nine months ended September 30, 2003, respectively. Since we did not own these businesses in the corresponding periods in 2002, we did not record minority interest for those periods.

*Gain on Divestitures, Net.* We recorded a net gain of \$9.9 million related to the divestiture of several product lines and related assets. In April 2003, we licensed intellectual property and manufacturing rights to the SurgiFrost cardiac product line, and sold the related inventory and fixed assets, to CryoCath. We reported a total gain on this transaction of approximately \$10 million in the second quarter of 2003. Also in April 2003, we sold the intangibles and inventory related to our Dura II products to American Medical Systems for \$2.2 million resulting in a \$35,000 loss.

*Net Loss.* Net loss for the three months ended September 30, 2003 was \$11,113,000 or \$0.46 per diluted share on 24,182,004 weighted average shares outstanding, compared to a net loss of \$4,725,000, or \$0.19 per share on 24,279,000 weighted average shares outstanding for the same period in 2002. The loss for the three months ended September 30, 2003 as compared to net loss for the same period in 2002 increased as a result of higher selling, general and administrative expenses due to significant non-recurring costs associated with accounting investigations.

Our net loss for the nine months ended September 30, 2003 was \$15,539,000, or \$.64 per diluted share, on 24,163,235 weighted average shares outstanding, compared to a net loss of \$13,403,000, or \$.56 per share, on 23,695,667 weighted average shares outstanding for the same period in 2002.

## **Liquidity and Capital Resources**

Since inception, we have incurred losses from operations and have reported negative cash flows. As of September 30, 2003, we had an accumulated deficit of \$104.5 million and cash and cash equivalents of \$29.7 million. We currently have no long-term debt, and no long-term financial obligations other than under operating leases and purchase commitments for raw material used in manufacturing our products. Although we believe that our existing cash and marketable securities will be sufficient to fund our working capital requirements, capital expenditures and other obligations through 2004, there are certain risks and uncertainties that could, in the future, change our opinion regarding the adequacy of our capital.

After September 30, 2003, our cash reserves continued to decline. From October 1, 2003 through March 31, 2004, our cash was principally used to fund a total of \$18.5 million in operating losses, including \$6.7 million in non-recurring legal and accounting fees associated with the on-going investigations of our historical accounting and financial reporting and \$0.3 million in executive severance costs. These expenses were partially offset by \$2.5 million in proceeds from the sale of our cardiac related product manufacturing operations to CryoCath.

In addition to the payments described in the prior paragraph, in February 2004 we paid approximately \$1.5 million in directors' and officers' liability insurance premiums, and we paid approximately \$1.9 million to BioLife to settle litigation, as described above in Note 7 to our condensed consolidated financial statements. During the first quarter of 2004 we incurred approximately \$3.3 million in non-recurring legal and accounting fees associated with the ongoing investigations into possible irregularities in our accounting and financial reporting in earlier periods.

We face the possibility that there will be additional material cash payments required in connection with resolving matters related to the investigations into our historical accounting and financial reporting. We and certain former officers and certain current and former board members have been named defendants in a class action and a derivative lawsuit. We are generally obliged, to the extent permitted by law, to indemnify our directors and officers who are named defendants in these lawsuits. At this point in time we are unable to provide a reasonable estimate of our potential liability in these lawsuits.

We may be required to pay judgments or settlements and to incur expenses in defending against these claims that could be material. Further, while we carry \$20 million of directors' and officers' liability insurance coverage, this coverage may not be adequate to cover all costs related to these lawsuits, including any resulting judgments or settlements. As described below under **Risks Related to Our Business**, for claims asserted

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during the period from June 10, 2002 through June 10, 2003, our three excess carriers have filed arbitration complaints, contending our former management made misstatements or omissions in the applications for insurance coverage and seeking rescission of the policies. A claim in excess of our insurance coverage would have to be paid out of cash reserves, which could have a material adverse effect on our business, financial condition, results of operations and cash flows.

Beyond the factors described above, we expect to face significant demands on our capital resources related to the execution of our 2004 operating plan, regaining compliance with the SEC rules and regulations required of publicly traded companies, including Section 404 of the Sarbanes-Oxley Act of 2002, and fulfilling requirements prerequisite to becoming re-listed on a national stock exchange or market. We incurred total losses of \$25.4 million in 2003 and are currently projecting an operating loss for fiscal 2004, as well as a net use of cash.

We will continue to use cash reserves to finance our projected 2004 cash flow deficit. Our 2004 forecast provides for an increase in revenues and improvement in gross profit as well as a reduction in general and administrative expenses. The reduction in general and administrative costs is due partly to the winding down of certain activities related to various investigations of accounting and financial reporting matters and reductions in both staffing and marketing programs. In addition, we have trimmed general and administrative costs through the elimination of redundant functions at our subsidiaries and centralizing them at our Irvine, California headquarters, and plan to continue cost reduction programs aimed at improving our financial health.

At the same time, however, we have planned certain strategic investments in sales and marketing activities to increase our market penetration as well as in inventory related to the introduction of our new Cryocare CS System. We have also planned expenditures on staffing and infrastructure improvements in finance and information technology to ensure that we will be able to comply with internal control and other SEC requirements.

## **Risks Related to Our Business**

*The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also impair our operations. The occurrence of any of the following risks could harm our business. In that case, the trading price of our common stock could decline, and you may lose all or part of your investment.*

### ***Our success will depend on our ability to attract and retain key personnel.***

In order to execute our business plan, we need to attract, retain and motivate a significant number of highly qualified managerial, technical, financial and sales personnel. If we fail to attract and retain skilled scientific and marketing personnel, our research and development and sales and marketing efforts will be hindered. Our future success depends to a significant degree upon the continued services of key management personnel, including Craig T. Davenport, our Chief Executive Officer, William J. Nydam, our President and Chief Operating Officer, and Katherine Greenberg, our Senior Vice President and Chief Financial Officer. None of our key management personnel is covered by an insurance policy of which we are the beneficiary.

### ***Our management members have spent considerable time and effort dealing with internal and external investigations and re-auditing of financial statements.***

In addition to the challenges of the SEC investigation, the DOJ investigation, a shareholder class-action and a derivative lawsuit and other legal proceedings described below, our new management members have spent considerable time and effort dealing with internal and external investigations involving our previous internal controls, accounting policies and procedures, disclosure controls and procedures and corporate governance policies and procedures. The significant time and effort spent has adversely affected our operations and may continue to do so in the future.

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***We face risks relating to our liquidity.***

Since the fourth quarter of 2002, we have incurred significant costs related to, among other things, legal, accounting and other professional fees associated with our internal reviews of various accounting and other matters, the ongoing investigation of us by the SEC and DOJ, various shareholder class-action and derivative lawsuits and other legal proceedings described below. In addition we are making significant investments in the development and implementation of sound internal controls and corporate governance policies and procedures designed to enhance the accuracy, quality and consistency of our financial information and reporting. We will continue to incur significant related expenses in the future.

If we are not able to significantly grow market share, improve our gross margins and reduce our operating expenses, or if we become subject to significant judgments or settlements in connection with the legal proceedings described in Part II, Item 1 of this Quarterly Report on Form 10-Q, we will require additional financing. Additional equity or debt financing may not be available on acceptable terms, or at all, in part because our common stock was de-listed from The Nasdaq Stock Market. If we are unable to obtain additional capital, we may be required to reduce our sales and marketing activities, reduce the scope of or eliminate our research and development programs, relinquish rights to technologies that we might otherwise seek to develop or commercialize, or sell certain assets.

We recently made several significant payments that have reduced our cash reserves. On March 8, 2004, we paid to our former Chief Executive Officer an aggregate of \$750,000, which we owed to him under a separation agreement and consulting agreement that we previously executed. Also on March 8, 2004, we paid to our former Chief Financial Officer an aggregate of \$616,000, which we owed to him under an employment agreement we previously executed. At the request of the SEC, these payments were deposited into escrow accounts during the fourth quarter of 2003; the funds were released upon termination of the related escrow agreements. Additionally, on February 20, 2004, we paid approximately \$1.5 million in directors and officers liability insurance premiums. Furthermore, as described below in Part II, Item 1 of this Quarterly Report on Form 10-Q, in February 2004 we paid approximately \$1.9 million to BioLife to settle litigation.

If we fail to adequately address our liquidity concerns, then our independent auditors may issue a qualified opinion, to the effect that there is substantial doubt about our ability to continue as a going concern. A qualified opinion could itself have a material adverse effect on our business, financial condition, results of operations and cash flows.

For a further description of the nature of the risks relating to our liquidity see, Part I, Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources.

***We have limited operating experience and a history of net losses, and we may never reach or maintain profitability.***

We have limited experience in manufacturing, marketing and selling our Cryocare Surgical System in commercial quantities. In addition, during 2002, we completed our acquisitions of Timm Medical, the cryosurgical assets of BioLife, and our acquisition of the mobile prostate treatment businesses owned by USMD. As a result, we have a short history in marketing and selling the products we acquired or have rights to commercialize through these acquisitions or to market our products on the scale required by these acquisitions. In addition, we have limited experience in managing the complex demands of a business with multiple entities and locations, a large workforce and diverse information technology systems.

We have incurred annual operating losses each year since our inception. For the quarter ended March 31, 2004, we had losses from operations of approximately \$8.6 million. As of March 31, 2004, our accumulated deficit was approximately \$123.0 million. It is possible that we will not generate sufficient revenues from product sales and service revenues to achieve or sustain profitability. Even if we do achieve significant

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revenues from our product sales and service revenues, we expect that increased operating expenses will result in significant operating losses over the next several quarters, as we, among other things:

expand our infrastructure to support more robust internal controls, including policies and procedures related to our accounting practices, disclosure controls and corporate governance;

incur costs related to legal proceedings, including ongoing government investigations;

expand our sales and marketing activities as we attempt to gain market share for our Cryocare Surgical System; and

continue our research and development efforts to improve our existing products and develop new products.

We will need to significantly increase the revenues we receive from sales of our products and services as a result of these increased operating expenses. We may be unable to do so, and therefore, may not achieve profitability.

Even if we do achieve profitability, we cannot be certain that we will be able to sustain or increase profitability on a quarterly or annual basis.

### ***If we require future capital, we may not be able to secure additional funding in order to expand our operations and develop new products.***

If we fail to achieve and maintain profitability and positive cash flow, or if we undertake or accelerate significant research and development projects for new products or pursue corporate acquisitions, we may need additional outside financing. We may raise these additional funds by selling one or more lines of business or products, selling our equity securities, incurring debt or entering into collaborative arrangements. Any additional equity financing may be dilutive to stockholders, and debt financing, if available, may involve interest expense and restrictive covenants. Collaborative arrangements, if necessary to raise additional funds, may require us to relinquish rights to some of our technologies, products or marketing territories. Our failure to raise capital when needed could have a material adverse effect on our business, financial condition, results of operations and cash flows.

### ***We cannot assure you that we will not discover additional instances of historical breakdowns in controls, policies and procedures affecting our previously issued financial statements.***

We have made significant changes in our internal controls, accounting policies and procedures, disclosure controls and procedures and corporate governance policies and procedures throughout 2003 and the first quarter of 2004. While we believe that our newly implemented controls, policies and procedures will help to prevent the occurrence of financial reporting problems in the future, it is possible that we may discover additional instances of historical breakdowns in our internal controls, policies and procedures of the types that led to restatements of our financial statements for the years 2000 and 2001 and for the first two quarters of 2002. In the event such breakdowns are discovered they could impact both historical financial statements and future reported results.

### ***We face risks related to investigations by the SEC and DOJ and related to other legal proceedings.***

The SEC and the DOJ are conducting investigations into allegations that we and certain of our current and former officers and directors issued or caused to be issued false and misleading statements regarding our revenues and expenses in press releases and SEC filings. Although we have fully cooperated with these governmental agencies in these matters and intend to continue to fully cooperate, these agencies may determine we have violated federal securities laws. We cannot predict when these investigations will be completed or their outcomes. If it is determined that we have violated federal securities laws or other laws or regulations, we may face sanctions, including, but not limited to, significant monetary penalties and injunctive relief.

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In addition, we and certain former officers and certain current and former board members have been named defendants in a class action and a derivative lawsuit. The findings and outcome of the investigations described above may affect the class action and the derivative lawsuit that are pending. We are generally obliged, to the extent permitted by law, to indemnify our directors and officers who are named defendants in some of these lawsuits. We are unable to estimate what our liability in these matters may be, and we may be required to pay judgments or settlements and incur expenses in aggregate amounts that could have a material adverse effect on our business, financial condition, results of operations and cash flows.

We have \$20 million of directors' and officers' liability insurance coverage. The coverage is provided in four \$5 million policies issued by a primary insurance carrier and three excess insurance carriers. For claims asserted during the period from June 10, 2002 through June 10, 2003, the three excess carriers have filed arbitration complaints, contending our former management made misstatements or omissions in the applications for insurance coverage and seeking rescission of the policies. A claim in excess of our insurance coverage would have to be paid out of cash reserves, which could have a material adverse effect on our business, financial condition, results of operations and cash flows.

### ***Our investors, customers, vendors and suppliers may react adversely to the restatement of our historical financial statements and our inability to timely file all of our SEC filings.***

Our future success depends in large part on the support of our investors, customers, vendors, and suppliers. The restatement of our historical financial statements and our inability to timely file all of our SEC filings has resulted in negative publicity about us and has, and may continue to have, a negative impact on the market price of our common stock. The restatement of our historical financial statements and our inability to timely file all of our SEC filings also could cause some of our customers or potential customers to refrain from purchasing or to defer or cancel purchases of our products. Additionally, our current and potential vendors and suppliers may re-examine their willingness to do business with us, to develop critical interfaces for us or to supply products and services if they lose confidence in our ability to fulfill our commitments.

### ***Our common stock was de-listed from the Nasdaq Stock Market and, as a result, trading of our common stock has become more difficult.***

Our common stock was de-listed from The Nasdaq Stock Market on January 16, 2003. One result of this action is a limited public market for our common stock. Trading is now conducted in the over-the-counter market in the so-called Pink Sheets. Consequently, selling our common stock is more difficult because smaller quantities of shares can be bought and sold, transactions can be delayed and security analyst and news media coverage of us may be reduced. These factors could result in lower prices and larger spreads in the bid and ask prices for shares of our common stock as well as lower trading volume. Although we will seek to have our common stock re-listed on a national stock exchange or market once we are in full compliance with our obligations as a reporting company, we can provide no assurance that we will be re-listed.

As a result of the delisting of our common stock from The Nasdaq Stock Market, our common stock has become subject to the penny stock regulations, including Rule 15c-2 under the Securities Exchange Act of 1934. That rule imposes additional sales practice requirements on broker-dealers that sell low-priced securities to persons other than established customers and institutional accredited investors. For transactions covered by this rule, a broker-dealer must make a special suitability determination for the purchaser and have received the purchaser's written consent to the transaction prior to sale. Consequently, the rule may affect the ability of broker-dealers to sell our common stock and affect the ability of holders to sell their shares of our common stock in the secondary market. To the extent our common stock remains subject to the penny stock regulations, the market liquidity for the shares will be adversely affected.

### ***We expect to derive a significant portion of our future revenues from our cryosurgical products, which could fail to achieve market acceptance or generate significant revenue.***

We introduced our Cryocare Surgical System to the market in July 1999. We derived a significant portion of our revenues in 2001 and 2002 from sales of Cryocare Surgical Systems and related disposable cryoprobe

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and temperature probes, as well as from per-procedure fees. In 2003, we shifted our business model to focus on sales of procedures and disposable devices rather than on sales of Cryocare Surgical Systems. We expect sales of cryosurgical products and the related procedure fees will constitute a significant portion of our revenues for the foreseeable future, although we expect revenue from system sales to fluctuate from quarter to quarter and decrease, over time, as a percentage of our revenue.

Our success is reliant on the acceptance by doctors and patients of the Cryocare Surgical System as a preferred treatment for tumor ablation. Cryosurgery has existed for many years, but has not been widely accepted primarily due to concerns regarding safety and efficacy and widespread use of alternative therapies. Because the technology previously lacked precise monitoring capabilities, cryosurgical procedures performed in the 1970s resulted in high cancer recurrence and negative side effects, such as rectal fistulae and incontinence, and gave cryosurgical treatment negative publicity. To overcome these negative side effects, we have developed ultrasound guidance and temperature sensing to enable more precise monitoring in our Cryocare Surgical System. Nevertheless, we will need to overcome the earlier negative publicity associated with cryosurgery in order to obtain market acceptance for our products. In addition, use of our Cryocare Surgical System requires significant physician education and training. As a result, we may have difficulty obtaining recommendations and endorsements of physicians and patients for our Cryocare Surgical System. We may also have difficulty raising the brand awareness necessary to generate interest in our Cryocare Surgical System. Any adverse side effects, including impotence or incontinence, recurrence of cancer or future reported adverse events or other unfavorable publicity involving patient outcomes from the use of cryosurgery, whether from our products or the products of our competitors, could adversely affect acceptance of cryosurgery. In addition, emerging new technologies and procedures to treat cancer, prostate enlargement and other prostate disorders may negatively affect the market acceptance of cryosurgery. If our Cryocare Surgical System does not achieve broad market acceptance, we will likely remain unprofitable.

### ***If we are unable to continue to develop and enhance our Cryocare Surgical System, our business will suffer.***

Our growth depends in part on our continued ability to successfully develop enhancements to our Cryocare Surgical System. We may experience difficulties that could delay or prevent the successful development and commercialization of these products. Our products in development may not prove safe and effective in clinical trials. Clinical trials may identify significant technical or other obstacles that must be overcome before obtaining necessary regulatory or reimbursement approvals. In addition, our competitors may succeed in developing commercially viable products that render our products obsolete or less attractive. Failure to successfully develop and commercialize new products and enhancements would likely have a significant negative effect on our financial prospects.

### ***Our strategy of divesting non-core product lines may not be successful.***

We are refocusing our business on the development of minimally invasive technologies for tissue and tumor ablation. As part of this strategy, we have begun divesting certain non-core product lines, as evidenced by our sale of our Dura II Penile Prosthesis product line, our sale of our urodynamics and urinary incontinence product lines and our licensing of our cardiac technology and sale of related assets. We can provide no assurance that our strategy of focusing on our core technologies for tumor ablation applications and our divestitures of non-core technologies and product lines will be successful.

### ***There is uncertainty relating to third-party reimbursement, which is critical to market acceptance of our products.***

Hospitals and other health care providers in the United States generally rely on third-party payors, principally federal Medicare, state Medicaid and private health insurance plans, to reimburse all or part of the cost of medical procedures involving our products. While private health insurers in some areas of the United States provide reimbursement for procedures in which our products are used, we can provide no assurance that private insurance reimbursement will be adopted nationally or by additional insurers. Furthermore, those private insurance companies currently paying for procedures in which our products are used may terminate

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such coverage. If reimbursement levels from Medicare, Medicaid, other governmental health care programs or private insurers are not sufficient, physicians may choose not to recommend, and patients may not choose, procedures utilizing our products.

Previously, reimbursement under Medicare for our cryosurgical disposable products used in outpatient procedures was provided on a so-called pass-through basis. This enabled the hospital or other health care provider to obtain separate reimbursement for our disposable devices in addition to reimbursement for the procedure fee. Pass-through status was terminated on December 31, 2003. As a result, the cost of our disposable products now is incorporated into the Hospital Outpatient Prospective Payment System and there will be no separate reimbursement for the disposables.

Given the end to pass-through status for our disposable cryoprobes and temperature probes, we expect Medicare reimbursement for our products used in outpatient settings to continue to fluctuate. This may influence reimbursement rates for our products by private insurers as well. We can provide no assurance that changes in outpatient reimbursement rates will not affect our ability to negotiate favorable charges for our products to hospitals.

International market acceptance of our products may depend, in part, upon the availability of reimbursement within prevailing health care payment systems. Reimbursement and health care payment systems in international markets vary significantly by country, and include both government sponsored health care and private insurance. We may not obtain international reimbursement approvals in a timely manner, if at all. Our failure to receive international reimbursement approvals may negatively impact market acceptance of our products in the international markets in which those approvals are sought.

Furthermore, from time to time significant attention has been focused on reforming the health care system in the United States and other countries. Any changes in Medicare, Medicaid or third-party medical expense reimbursement, which may arise from health care reform, may have a material adverse effect on reimbursement for our products or procedures in which our products are used and may reduce the price we are able to charge for our products. In addition, changes to the health care system may also affect the commercial acceptance of products we are currently developing and products we may develop in the future. Potential approaches that have been considered include controls on health care spending and price controls. Several proposals have been made in the United States Congress and various state legislatures recently that, if adopted, would potentially reduce health care spending, which may result in a material adverse effect on our business, financial condition, results of operations and cash flows.

***We have limited sales and marketing experience with our Cryocare Surgical System and any failure to significantly expand sales of this product will negatively impact future revenue.***

We primarily handle the marketing, distribution and sales of our Cryocare Surgical Systems through our own work force. We have limited experience marketing and selling our Cryocare Surgical System in commercial quantities or on a nationwide basis. We will face significant challenges and risks in training, managing and retaining our sales and marketing teams, including managing geographically dispersed efforts and adequately training our people in the use and benefits of our Cryocare Surgical System. We may not be able to hire significant additional personnel or deploy sufficient other resources needed to create increased demand for our Cryocare Surgical System. In addition, we have distribution arrangements, some of which are exclusive, for the sale of our Cryocare Surgical System both domestically and internationally, and we are dependent upon the sales and marketing efforts of our third-party distributors. These distributors may not commit the necessary resources to effectively market and sell our Cryocare Surgical System. If we are unable to expand our sales and marketing capabilities or if our senior sales and marketing personnel are not retained, we may not be able to effectively commercialize our Cryocare Surgical System.

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***We acquired Timm Medical, the cryosurgical assets of BioLife and the mobile prostate treatment businesses of USMD and face risks associated with integrating these businesses into our existing business operations.***

We continue to face numerous risks and expenses related to integration of the businesses we acquired from Timm Medical, BioLife and USMD. In addition, the acquired businesses have suffered because management's resources have been consumed by, among other things, the internal and external investigations involving various accounting and related matters as well as the work involved in re-auditing and restating our consolidated financial statements for the years ended December 31, 2000 and 2001 and for the first two quarters of 2002. The businesses acquired from Timm Medical have suffered because resources have been diverted in divesting certain non-core product lines and in downsizing our Eden Prairie operations. The businesses we acquired from USMD have suffered for many of the same reasons in addition to the fact that we recently assumed administrative responsibility for management of these complex businesses. If we do not successfully integrate and grow the acquired businesses, our business will suffer.

***Introduction of alternative therapies may affect our revenues.***

We sell medical devices for the treatment of certain urological disorders. If physicians and patients do not accept our products, our sales will decline. Patient acceptance of our products depends on a number of factors, including the failure of other therapies, the degree of invasiveness involved, the rate and severity of complications from the procedures, and other adverse side effects. Patients are more likely first to consider non-invasive alternatives to treat their urological disorders. The introduction of new oral medications or other less-invasive therapies may cause our sales to decline in the future.

***We could be difficult to acquire due to anti-takeover provisions in our charter, our stockholders rights plan and Delaware law.***

Provisions of our certificate of incorporation and bylaws, as amended, may have the effect of making it more difficult for a third party to acquire, or of discouraging a third party from attempting to acquire, control of us. In addition, in April 1999, our Board of Directors adopted a stockholder rights plan in which preferred stock purchase rights were distributed as a dividend. These provisions may make it more difficult for stockholders to take corporate actions and may have the effect of delaying or preventing a change in control. We are subject to the anti-takeover provisions of Section 203 of the Delaware General Corporation Law. Subject to specified exceptions, this section provides that a corporation may not engage in any business combination with any interested stockholder during the three-year period following the time that such stockholder becomes an interested stockholder. This provision could have the effect of delaying or preventing a change of control of us. The foregoing factors could limit the price that investors or an acquiror might be willing to pay in the future for shares of our common stock.

***If we fail to protect our intellectual property rights, our competitors may take advantage of our ideas and compete directly against us.***

Our success will depend to a significant degree on our ability to secure and protect intellectual property rights and to enforce patent and trademark protections relating to our technology. From time to time, litigation may be advisable to protect our intellectual property position. However, these legal means afford only limited protection and may not adequately protect our rights or permit us to gain or keep any competitive advantage. Any litigation in this regard could be costly, and it is possible that we will not have sufficient resources to fully pursue this litigation or to protect our other intellectual property rights. It could result in the rejection or invalidation of our existing and future patents. Any adverse outcome in litigation relating to the validity of our patents, or any failure to pursue litigation or otherwise to protect our patent position, could have a material adverse effect on our business, financial condition, results of operations and cash flows. Also, even if we prevail in litigation, the litigation would be costly in terms of management distraction as well as in money. In addition, confidentiality agreements with our employees, consultants, customers, and key vendors may not prevent the unauthorized disclosure or use of our technology. It is possible that these agreements will be breached or that they will not be enforceable in every instance, and that we will not have adequate remedies for any such

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breach. Enforcement of these agreements may be costly and time consuming. Furthermore, the laws of foreign countries may not protect our intellectual property rights to the same extent as the laws of the United States.

***Because the medical device industry is litigious, we may be sued for allegedly violating the intellectual property rights of others.***

The medical technology industry has in the past been characterized by a substantial amount of litigation and related administrative proceedings regarding patents and intellectual property rights. In addition, major medical device companies have used litigation against emerging growth companies as a means of gaining or preserving a competitive advantage.

Should third parties file patent applications or be issued patents claiming technology also claimed by us in pending applications, we may be required to participate in interference proceedings in the U.S. Patent and Trademark Office to determine the relative priorities of our inventions and the third parties' inventions. We could also be required to participate in interference proceedings involving our issued patents and pending applications of another entity. An adverse outcome in an interference proceeding could require us to cease using the technology or to license rights from prevailing third parties.

Third parties may claim we are using their patented inventions and may go to court to stop us from engaging in our normal operations and activities. These lawsuits are expensive to defend and conduct and would also consume and divert the time and attention of our management. A court may decide that we are infringing a third party's patents and may order us to cease the infringing activity. A court could also order us to pay damages for the infringement. These damages could be substantial and could have a material adverse effect on our business, financial condition, results of operations and cash flows.

If we are unable to obtain any necessary license following an adverse determination in litigation or in interference or other administrative proceedings, we would have to redesign our products to avoid infringing a third party's patent and could temporarily or permanently have to discontinue manufacturing and selling some of our products. If this were to occur, it would negatively impact future sales and, in turn, our business, financial condition, results of operations and cash flows.

***We have limited experience manufacturing our products and if we are unable to meet customer demand, we may not become profitable.***

We use internal manufacturing capacity and expertise to manufacture our products. We have limited experience in producing our products in commercial quantities. We may encounter difficulties in scaling up production of new products, including problems involving production yields, quality control and assurance, component supply and shortages of qualified personnel. Our failure to overcome these manufacturing problems could have a material adverse effect on our business, financial condition, results of operations and cash flows.

Our success will depend in part upon our ability to manufacture our products in compliance with the FDA's Quality System regulations and other regulatory requirements in sufficient quantities and on a timely basis, while maintaining product quality and acceptable manufacturing costs.

***We are dependent upon a number of third-party suppliers to manufacture our products and the loss of any of these suppliers could harm our business.***

We depend upon a number of unaffiliated third-party suppliers for components and materials used in the manufacture of our products and, as such, our business would be seriously harmed if we were unable to develop and maintain relationships with suppliers that allow us to obtain sufficient quantities and quality materials and components on acceptable terms. If our principal suppliers cease to supply the materials and components we need to manufacture our products, the qualification of additional or replacement suppliers could be a lengthy process and there may not be adequate alternatives to meet our needs, which will have a material adverse effect on our business, financial condition, results of operations and cash flows. We may not

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be able to obtain the necessary components and materials used in our products in the future on a timely basis, if at all.

***If we fail to obtain or maintain necessary regulatory clearances or approvals for products, or if approvals are delayed or withdrawn, we will be unable to commercially distribute and market our products or any product modifications.***

Government regulation has a significant impact on our business. Government regulation in the United States and other countries is a significant factor affecting the research and development, manufacture and marketing of our products. In the United States, the FDA has broad authority under the federal Food, Drug and Cosmetic Act to regulate the distribution, manufacture and sale of medical devices. Foreign sales of drugs and medical devices are subject to foreign governmental regulation and restrictions, which vary from country to country. The process of obtaining FDA and other required regulatory clearances and approvals is lengthy and expensive. We may not be able to obtain or maintain necessary approvals for clinical testing or for the manufacturing or marketing of our products. Failure to comply with applicable regulatory approvals can, among other things, result in fines, suspension or withdrawal of regulatory approvals, product recalls, operating restrictions, and criminal prosecution. In addition, governmental regulations may be established which could prevent, delay, modify or rescind regulatory approval of our products. Any of these actions by the FDA, or change in FDA regulations, could have a material adverse effect on our business, financial condition, results of operations and cash flows.

Regulatory approvals, if granted, may include significant limitations on the indicated uses for which our products may be marketed. In addition, to obtain such approvals, the FDA and foreign regulatory authorities may impose numerous other requirements on us. FDA enforcement policy prohibits the marketing of approved medical devices for unapproved uses. In addition, product approvals can be withdrawn for failure to comply with regulatory standards or unforeseen problems following initial marketing. We may not be able to obtain or maintain regulatory approvals for our products on a timely basis, or at all, and delays in receipt of or failure to receive such approvals, the loss of previously obtained approvals, or failure to comply with existing or future regulatory requirements could have a material adverse effect on our business, financial condition, results of operations and cash flows.

***Our products may be subject to product recalls even after receiving FDA clearance or approval, which would harm our reputation and our business.***

The FDA and similar governmental authorities in other countries have the authority to request and, in some cases, require the recall of our products in the event of material deficiencies or defects in design or manufacture. A governmental mandated or voluntary recall by us could occur as a result of component failures, manufacturing errors or design defects. Any recall of product would divert managerial and financial resources and harm our reputation with customers and our business.

***We could be negatively impacted by future interpretation or implementation of the federal Stark law and other federal and state anti-referral laws.***

The federal Stark law prohibits a physician from referring medical patients for certain services to an entity with which the physician has a financial relationship. A financial relationship includes both investment interests in an entity and compensation arrangements with an entity. Many states have similar and often broader laws prohibiting referrals by any licensed health care provider to entities with which they have a financial relationship. These state laws generally apply to services reimbursed by both governmental and private payors. Violation of these federal and state laws may result in prohibition of payment for services rendered, loss of licenses, fines, criminal penalties and exclusion from governmental and private payor programs, among other things. We have financial relationships with physicians and physician-owned entities, which in turn have financial relationships with hospitals and other providers of designated health services. Although we believe that our financial relationships with physicians and physician-owned entities, as well as the relationships between physician-owned entities that purchase or lease our products and hospitals, are not in violation of applicable laws and regulations, governmental authorities might take a contrary position. If our

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financial relationships with physicians or physician-owned entities or the relationships between those entities and hospitals were found to be illegal, we and/or the affected physicians and hospitals could be subject to civil and criminal penalties, including fines, exclusion from participation in government and private payor programs and requirements to refund amounts previously received from government and private payors. In addition, expansion of our operations to new jurisdictions, or new interpretations of laws in our existing jurisdictions, could require structural and organizational modifications of our relationships with physicians, physician-owned entities and others to comply with that jurisdiction's laws.

### ***If we become subject to claims, we may be required to pay damages that exceed our insurance coverage.***

Our business exposes us to potential product liability claims that are inherent in the testing, production, marketing and sale of medical devices. We are also subject to various other claims as described below in Part II, Item 1 Legal Proceedings. While we believe that we are reasonably insured against these risks, we may not be able to maintain insurance in amounts or scope sufficient to provide us with adequate coverage against all potential liabilities. A claim in excess of our insurance coverage would have to be paid out of cash reserves, which could have a material adverse effect on our business, financial condition, results of operations and cash flows. In addition, any product liability claim likely would harm our reputation in the industry and our business.

We have \$20 million of directors' and officers' liability insurance coverage. The coverage is provided in four \$5 million policies issued by a primary insurance carrier and three excess insurance carriers. For claims asserted during the period from June 10, 2002 through June 10, 2003, the three excess carriers have filed arbitration complaints, contending our former management made misstatements or omissions in the applications for insurance coverage and seeking rescission of the policies. A claim in excess of our insurance coverage would have to be paid out of cash reserves, which could have a material adverse effect on our business, financial condition, results of operations and cash flows.

### ***We are faced with intense competition and rapid technological and industry change, which may make it more difficult for us to achieve significant market penetration.***

The medical device industry generally, and the urological disease treatment market in particular, are characterized by rapid technological change, changing customer needs, and frequent new product introductions. If our competitors' existing products or new products are more effective than or considered superior to our products, the commercial opportunity for our products will be reduced or eliminated. We face intense competition from companies in the cryosurgical marketplace as well as companies offering other treatment options, including radical surgery, radiation therapy and hormone therapy. If we are successful in penetrating the market for treatment of prostate cancer with our cryosurgical treatment, other medical device companies may be attracted to the marketplace. Many of our potential competitors are significantly larger than we are and have greater financial, technical, research, marketing, sales, distribution and other resources than we do. We believe there will be intense price competition for products developed in our markets. Our competitors may develop or market technologies and products, including drug-based treatments, that are more effective or commercially attractive than any that we are developing or marketing. Our competitors may obtain regulatory approval, and introduce and commercialize products before we do. These developments could have a material adverse effect on our business, financial condition, results of operations and cash flows. Even if we are able to compete successfully, we may not be able to do so in a profitable manner.

### ***Fluctuations in our future operating results may negatively impact the market price of our common stock.***

Our operating results have fluctuated in the past and can be expected to fluctuate from time to time in the future. Some of the factors that may cause these fluctuations include the following:

- impact of legal proceedings;

- costs of expanding our infrastructure to support more robust internal controls, including more effective policies and procedures;

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costs to strengthen our accounting practices, disclosure controls and corporate governance;

market acceptance of our existing products, as well as products in development;

timing of payments received and the recognition of such payments as revenue under collaborative arrangements and strategic alliances;

ability to manufacture products efficiently;

timing of our research and development expenditures;

timing of customer orders;

changes in reimbursement rates for our products and procedures by Medicare and other third-party payors;

potential impact of acquisitions;

timing of regulatory approvals for new products;

outcomes of clinical studies by us or our competitors;

competition from other treatment modalities; and

physician and patient acceptance of cryosurgery.

If our operating results are below the expectations of securities analysts or investors, the market price of our common stock may fall abruptly and significantly.

***Our stock price may be volatile and your investment could decline in value.***

Our stock price has fluctuated significantly in the past and is likely to continue to fluctuate significantly, making it difficult to resell shares when investors want to at prices they find attractive. The market prices for securities of emerging companies have historically been highly volatile. Future events concerning us or our competitors could cause such volatility including:

actual or anticipated variations in our operating results;

developments regarding government and third-party reimbursement;

changes in government regulation of our products and business practices;

developments concerning government investigation of us;

developments concerning proprietary rights;

developments concerning litigation or public concern as to the safety of our products or our competitors' products;

technological innovations or introduction of new products by us or our competitors;

investor and analyst perception of us and our industry;

general economic and market conditions; and

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physician and patient acceptance of cryosurgery.

In addition, the stock market is subject to price and volume fluctuations that affect the market prices for companies in general, and small-capitalization, high technology companies in particular, which are often unrelated to the operating performance of these companies.

***Future sales of shares of our common stock may negatively affect our stock price.***

Future sales of our common stock, including shares issued upon the exercise of outstanding options and warrants or hedging or other derivative transactions with respect to our stock, could have a significant negative

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effect on the market price of our common stock. These sales also might make it more difficult for us to sell equity securities or equity-related securities in the future at a time and price that we would deem appropriate.

### ***Our intangible assets and goodwill could become impaired.***

Intangible assets acquired in a purchase, such as intellectual property or developed technology, are generally amortized over various periods depending on their anticipated economic benefits or useful lives. Long-lived assets, including amortizable intangibles, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. Following a review, if such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying value of the assets exceeds the fair value of the assets.

We had no reported goodwill prior to January 1, 2002. With the adoption of Statement of Financial Accounting Standards No. 142 Goodwill and Intangible Assets, goodwill can no longer be amortized against earnings. Goodwill balances are subject to an impairment review on an annual basis or sooner if indicators of potential impairment exist. The test for impairment requires us to first compare the fair value of the net assets of each reporting unit to their carrying value, including goodwill. If the fair value of the reporting unit is less than the carrying value, goodwill of the reporting unit is potentially impaired and we next calculate the implied fair value of goodwill by deducting the fair value of all tangible and intangible net assets of the reporting unit from the fair value of the reporting unit. If the implied fair value of goodwill is less than the carrying amount of goodwill, an impairment loss is recognized equal to the difference. In the fourth quarter of 2002, we recorded goodwill impairment related to our Timm Medical acquisition and an impairment of our investment in U.S. Medical Development, Inc. Significant estimates, including assumptions regarding future events and circumstances that cannot be easily predicted are required to perform an analysis of the value of goodwill. These estimates and assumptions may differ materially from actual outcomes and occurrences. Furthermore, no assurance can be given that we will not have further impairment charges related to Timm Medical or other acquisitions.

### ***Negative economic conditions in the United States may negatively impact our ability to achieve profitability.***

During the past several years, the United States and other international markets experienced a significant economic downturn. In addition, the United States and other countries suffered significant acts of hostility, terror and war. Such acts may increase or prolong such negative economic conditions. The economic downturn may impact our ability to maintain or increase profitability by negatively affecting growth in demand for our products. There can be no certainty as to the degree or severity of the duration of this downturn. We also cannot predict the extent and timing of the impact of the economic downturn in the United States and in other countries and geographic regions in which we conduct our business.

### ***Our facilities and systems are vulnerable to natural disasters or other catastrophic events.***

Our headquarters, cryosurgical products manufacturing facilities, research facilities and much of our infrastructure, including computer servers, are located in California, an area that is susceptible to earthquakes and other natural disasters. Our erectile dysfunction products are assembled, packaged and shipped in our Minneapolis facility. A natural disaster or other catastrophic event, such as an earthquake, fire, flood, severe storm, break-in, terrorist attack or other comparable problems could cause interruptions or delays in our business and loss of data or render us unable to accept and fulfill customer orders in a timely manner, or at all. In addition, as our Minneapolis facility is located in an area that is susceptible to harsh weather, a major storm, heavy snowfall or other similar event could prevent us from delivering products in a timely manner. We have no formal disaster recovery plan and our business interruption insurance may not adequately compensate us for losses that may occur. In the event that an earthquake, natural disaster or other catastrophic event were to destroy any part of our facilities or interrupt our operations for any extended period of time, or if harsh

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weather conditions prevent us from delivering products in a timely manner, our business, financial condition and operating results would be seriously harmed.

### **Item 3. *Quantitative and Qualitative Disclosures About Market Risk***

The primary objective of our investment activities is to preserve principal while at the same time maximizing the income we receive from our invested cash without significantly increasing risk of loss. Our financial instruments include cash, cash equivalents, short-term investments, accounts receivable, investments, accounts payable and accrued liabilities. The carrying values of our financial instruments approximated their fair values. Our policy is not to enter into derivative financial instruments. In addition, we do not enter into any futures or forward contracts and therefore, we do not have significant market risk exposure with respect to commodity prices.

Although we transact our business in U.S. dollars, future fluctuations in the value of the U.S. dollar may affect the price competitiveness of our products. However, we do not believe that we currently have any significant direct foreign currency exchange rate risk and have not hedged exposures denominated in foreign currencies or any other derivative financial instruments.

### **Item 4. *Controls and Procedures***

(a) *Evaluation of Disclosure Controls and Procedures.* As required by Securities and Exchange Commission Rule 13a-15(b), our Chief Executive Officer and our Senior Vice President, Chief Financial Officer have evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on their evaluation, our Chief Executive Officer and our Senior Vice President, Chief Financial Officer have concluded that our disclosure controls and procedures are not yet effective because, until the filing of this report and the other past due reports on Form 10-Q that we are filing concurrently with this report, we have not been current in our reporting under Section 15(d) of the Securities Exchange Act of 1934. Our inability to timely file the required reports is due to, among other things, the fact that management's time and attention have been consumed by the auditing and re-auditing of our financial statements for the years ended December 31, 2000, 2001, 2002 and 2003, and the resulting restatements, by the development and implementation of improvements to our internal controls and financial reporting processes, and by the internal and external investigations into the accounting and other matters described in our consolidated financial statements and the related notes contained in this report in Part I, Item 1 and in our Annual Reports on Form 10-K for the years ended December 31, 2002 and 2003 and in Part I, Item 2 of this report, Management's Discussion and Analysis of Financial Condition and Results of Operations.

Since March 2003, management has implemented and continues to implement significant changes in organization, policies and procedures designed to enhance our disclosure controls and procedures and the related internal controls. These include, among other measures: new restrictions and guidelines governing sales personnel, terms and conditions of sale and revenue recognition; new and more stringent credit approval policies; new policies governing approval, review and recording of expenditures and other legal and financial transactions; new procedures governing documentation and approval of options and warrants issued in connection with legal and financial transactions; and new internal reporting procedures. Nevertheless, during much of 2003, many of these enhancements to our disclosure controls and procedures and the related internal controls were not yet in place, or were only partially in place. For this reason, management has undertaken an extensive and substantive review and evaluation of all financial transactions that, individually or collectively, could have a material impact on the information contained in this Form 10-Q. These review procedures, in combination with the changes in internal control that have been implemented as of the date of the filing of this report, form the basis for our determination that the financial statements and other information contained in this report fairly present, in all material respects, our financial condition, results of operations and cash flows for the nine months ended September 30, 2003 and 2002.

(b) *Changes in Internal Controls.* Except as described above in subsection (a) of this Item 4, there was no change in our internal control over financial reporting during our third fiscal quarter for 2003 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

We are a party to lawsuits in the normal course of our business. Litigation and governmental investigation can be expensive and disruptive to normal business operations. Moreover, the results of complex legal proceedings are difficult to predict. We can provide no assurance that significant judgments or settlements in connection with the legal proceedings described below will not have a material adverse effect on our business, financial condition, results of operations and cash flows. See Note 7 to the condensed consolidated financial statements included herein and Part I, Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations. Other than as described below, we are not a party to any material legal proceedings.

In November 2002, we were named as a defendant, together with certain former officers, one of whom is also a former board member, in a class-action lawsuit filed in the United States District Court for the Central District of California. On February 2, 2003, the court issued an order consolidating this action with various other similar complaints and ordering plaintiffs to file a consolidated complaint, which was filed on October 31, 2003. The consolidated complaint asserts two claims for relief, alleging that the defendants violated sections of the Securities Exchange Act of 1934 by purportedly issuing false and misleading statements regarding our revenues and expenses in press releases and SEC filings. Plaintiffs seek class certification and unspecified damages from us, as well as forfeiture and reimbursement of bonus compensation received by two of the individual defendants. On April 26, 2004, the court issued an order denying our motion to dismiss the consolidated complaint. We intend to defend the case vigorously, but cannot assure you that it will be resolved in our favor.

On November 26, 2002, BioLife filed an action against us in the Delaware Court of Chancery seeking damages for alleged breaches of contract stemming from our acquisition, pursuant to an asset purchase agreement dated May 28, 2002, of the tangible and intangible assets related to BioLife's cryosurgical business. In the action, styled as BioLife Solutions, Inc. v. Endocare, Inc., Del. Ch., C.A. No. 20057-NC, BioLife alleged that we failed to timely register 120,022 shares of our common stock that were provided to BioLife in connection with the asset purchase agreement, in violation of a registration rights agreement relating to the shares that was executed in conjunction with the asset purchase agreement. BioLife sought damages of approximately \$1.6 million. We defended the action on the grounds that our obligation to register the shares was excused for various reasons, including as a consequence of BioLife's failure to transfer assets in accordance with the asset purchase agreement. Trial on all but one of the claims in the action was held during the week of March 31, 2003. On October 1, 2003, the Delaware Court ruled in favor of BioLife, awarding BioLife \$1,648,000, plus pre-judgment interest and costs (including legal fees), and requiring BioLife to surrender the 120,022 shares of our common stock to us. That ruling became an appealable final order and judgment on October 10, 2003. On February 20, 2004, we agreed with BioLife to settle all claims. As part of the settlement: we paid to BioLife \$1,887,000, which represented a discount of \$150,000 from the total judgment amount (including accrued interest and costs); BioLife returned to us the 120,022 shares of our common stock referred to above; and we agreed to abandon our appeal.

On December 6, 2002, Frederick Venables filed a purported derivative action against us and certain former officers and certain current and former board members in the California Superior Court for the County of Orange alleging breach of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets and unjust enrichment. On April 23, 2004, the parties filed a stipulation agreeing to a conditional stay of the action for 270 days, continuing the deadline to respond to the complaint until after expiration of the stay. The complaint seeks unspecified monetary damages, equitable relief and injunctive relief based upon allegations that the defendants issued false and misleading statements regarding our revenues and expenses in press releases and SEC filings. We intend to defend the case vigorously, but cannot assure you that it will be resolved in our favor.

The SEC is currently conducting an investigation to determine whether any federal securities laws were violated in connection with the filing of our financial statements for 2001 and the first two quarters of 2002,

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including investigation into allegations that we and certain of our current and former officers and directors issued or caused to be issued false and misleading statements regarding our revenues and expenses in those SEC filings. We are cooperating fully with this investigation. We cannot assure you that this matter will be resolved in our favor.

The DOJ is currently conducting an investigation into allegations that we and certain of our current and former officers and directors intentionally issued or caused to be issued false and misleading statements regarding our revenues and expenses in SEC filings. We are cooperating fully with this investigation. We cannot assure you that this matter will be resolved in our favor.

In December 2002, we filed a demand for arbitration before the American Arbitration Association in Minnesota against a former employee. The complaint included various claims in response to which the employee made several counterclaims. In March 2003, we were notified by the United States Department of Labor that counsel for the employee had presented a letter of complaint alleging that we and our former CEO and former CFO violated 18 U.S.C. §1514A by improperly retaliating against the employee. In December 2003, we and the employee agreed to settle all claims on mutually acceptable terms without the admission of liability by any party for an amount that is not significant. Pursuant to the settlement, the employee withdrew his letter of complaint, and the Department of Labor has indicated that it considers the matter closed.

In June 2003, we were awarded a favorable judgment for \$351,000 in a litigation matter previously initiated by Timm Medical against a third party. Since collection is not assured, any amount recovered in connection with this judgment will be recorded in the period when it is actually paid to us.

**Item 2. *Changes in Securities and Use of Proceeds***

None.

**Item 3. *Defaults Upon Senior Securities***

None.

**Item 4. *Submission of Matters to a Vote of Security Holders***

None.

**Item 5. *Other Information***

None.

**Item 6. *Exhibits and Reports on Form 8-K.*****(a) Exhibits**

| Exhibit No. | Description                                                                                                                                                                                                                                                                                                                                                                                       |
|-------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 2.1(1)      | Agreement and Plan of Reorganization dated February 21, 2002, by and among the Company, Technologies, Inc., TMT Acquisition Corporation and certain stockholders of Timm Medical Technologies, Inc. Certain schedules and other attachments to this exhibit were omitted. We agree to furnish supplementally a copy of any omitted schedules or attachments to the Commission upon request.       |
| 2.2(2)      | Agreement and Plan of Merger dated June 30, 1999, by and among the Company, Advanced Medical Procedures, Inc., Advanced Medical Procedures, LLC, Gary M. Onik, M.D., Robert F. Byrnes and Jerry Anderson. Certain schedules and other attachments to this exhibit were omitted. We agree to furnish supplementally a copy of any omitted schedules or attachments to the Commission upon request. |

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| <b>Exhibit No.</b> | <b>Description</b>                                                                                                                                                                                                                                                                                                                                                                                                  |
|--------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 2.3(3)             | Asset Purchase Agreement, dated February 6, 2002, by and between the Company and Gary M. Onik, M.D. Certain schedules and other attachments to this exhibit were omitted. We agree to furnish supplementally a copy of any omitted schedules or attachments to the Commission upon request.                                                                                                                         |
| 2.4(3)             | Asset Purchase Agreement dated May 28, 2002, by and among the Company and Cryomedical Sciences, Inc. Certain schedules and other attachments to this exhibit were omitted. We agree to furnish supplementally a copy of any omitted schedules or attachments to the Commission upon request.                                                                                                                        |
| 2.5(4)             | Partnership and Limited Liability Company Membership Interest Purchase Agreement, dated as of August 12, 2002, by and among Endocare, Inc. and U.S. Medical Development, Inc., U.S.M.D., Ltd. and U.S.M.D. I, L.L.C. Certain schedules and exhibits referenced in this exhibit have been omitted. We agree to furnish supplementally a copy of any omitted schedules or attachments to the Commission upon request. |
| 2.6(5)             | Amendment No. 1 to Partnership and Limited Liability Company Membership Interest Purchase Agreement, dated as of September 30, 2002, by and among Endocare, Inc. and U.S. Medical Development, Inc., U.S.M.D., Ltd. and U.S.M.D. I, L.L.C.                                                                                                                                                                          |
| 2.7(6)             | Agreement of Purchase and Sale, dated as of April 7, 2003, by and among American Medical Systems, Inc., the Company and Timm Medical Technologies, Inc.                                                                                                                                                                                                                                                             |
| 2.8(7)             | Asset Purchase and Technology License Agreement, dated as of April 29, 2003, by and between the Company and CryoCath Technologies Inc.                                                                                                                                                                                                                                                                              |
| 3.1(2)             | Certificate of Amendment of Restated Certificate of Incorporation of the Company.                                                                                                                                                                                                                                                                                                                                   |
| 3.2(2)             | Certificate of Designation of Series A Junior Participating Preferred Stock of the Company.                                                                                                                                                                                                                                                                                                                         |
| 3.3(2)             | Restated Certificate of Incorporation.                                                                                                                                                                                                                                                                                                                                                                              |
| 3.4(8)             | Amended and Restated Bylaws of the Company.                                                                                                                                                                                                                                                                                                                                                                         |
| 10.1(8)            | Consulting Agreement, dated as of August 27, 2003, by and between the Company and Craig T. Davenport.                                                                                                                                                                                                                                                                                                               |
| 10.2 (8)           | First Amendment to Employment Agreement, dated as of September 14, 2003, by and between the Company and Katherine Greenberg.                                                                                                                                                                                                                                                                                        |
| 31.1               | Certification under Section 302 of the Sarbanes-Oxley Act of 2002 for Craig T. Davenport.                                                                                                                                                                                                                                                                                                                           |
| 31.2               | Certification under Section 302 of the Sarbanes-Oxley Act of 2002 for Katherine Greenberg.                                                                                                                                                                                                                                                                                                                          |
| 32.1               | Certification under Section 906 of the Sarbanes-Oxley Act of 2002 for Craig T. Davenport.                                                                                                                                                                                                                                                                                                                           |
| 32.2               | Certification under Section 906 of the Sarbanes-Oxley Act of 2002 for Katherine Greenberg.                                                                                                                                                                                                                                                                                                                          |

\* We have requested confidential treatment with respect to certain portions of these documents.

Management contract or compensatory plan or arrangement

- (1) Previously filed as an exhibit with our Form 8-K filed on March 5, 2002.
- (2) Previously filed as exhibits with our Registration Statement on Form S-3 filed on September 20, 2001 and October 31, 2001.
- (3) Previously filed as exhibits with our Form 10-Q filed on August 14, 2002.
- (4) Previously filed as an exhibit with our Form 8-K filed on August 16, 2002.
- (5) Previously filed as an exhibit with our Form 8-K filed on October 15, 2002.
- (6) Previously filed as an exhibit with our Form 8-K filed on April 22, 2003.
- (7) Previously filed as an exhibit with our Form 8-K filed on April 29, 2003.
- (8) Previously filed as an exhibit with our Form 10-K filed on March 15, 2004.

**(b) Reports on Form 8-K**

We filed a Form 8-K under Item 5 on September 19, 2003 to report that our former independent auditor, KPMG LLP, had sent a letter to our audit committee dated September 16, 2003 advising the audit committee



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that KPMG LLP's report dated February 19, 2002, except as to notes 1 and 15, which were as of March 25, 2002, on our consolidated financial statements as of December 31, 2000, and for the years ended December 31, 2000 and 1999, could no longer be relied upon.

We filed a Form 8-K under Item 5 on September 24, 2003 to report that: (i) we had entered into a separation agreement, consulting agreement and release with Paul Mikus, our former chairman and chief executive officer, as well as an escrow agreement with respect to the termination payment and consulting fee payable to Mr. Mikus pursuant to his separation agreement and his consulting agreement; (ii) we had entered into an escrow agreement with John Cracchiolo, our former chief operating officer, chief financial officer and secretary, with respect to the termination payment payable to Mr. Cracchiolo pursuant to his employment agreement; (iii) Mr. Mikus had resigned as a member of our board of directors and as our chairman; and (iv) Terrence A. Noonan had been appointed to our board of directors.

We furnished a Form 8-K under Item 12 on September 26, 2003 to report the release of our re-audited financial results for the years ended December 31, 2000 and 2001, as well as the audited financial results for the year ended December 31, 2002.

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**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.

ENDOCARE, INC.

By: */s/ CRAIG T. DAVENPORT*

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Craig T. Davenport  
*Chief Executive Officer and Chairman of the Board  
(Duly Authorized Officer)*

By: */s/ KATHERINE GREENBERG*

---

Katherine Greenberg  
*Senior Vice President and Chief Financial Officer  
(Principal Financial and Accounting Officer)*

Date: June 28, 2004

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| <b>Exhibit No.</b> | <b>Description</b>                                                                                                                                                                                                                                                                                                                                                                                                  |
|--------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 2.1(1)             | Agreement and Plan of Reorganization dated February 21, 2002, by and among the Company, Technologies, Inc., TMT Acquisition Corporation and certain stockholders of Timm Medical Technologies, Inc. Certain schedules and other attachments to this exhibit were omitted. We agree to furnish supplementally a copy of any omitted schedules or attachments to the Commission upon request.                         |
| 2.2(2)             | Agreement and Plan of Merger dated June 30, 1999, by and among the Company, Advanced Medical Procedures, Inc., Advanced Medical Procedures, LLC, Gary M. Onik, M.D., Robert F. Byrnes and Jerry Anderson. Certain schedules and other attachments to this exhibit were omitted. We agree to furnish supplementally a copy of any omitted schedules or attachments to the Commission upon request.                   |
| 2.3(3)             | Asset Purchase Agreement, dated February 6, 2002, by and between the Company and Gary M. Onik, M.D. Certain schedules and other attachments to this exhibit were omitted. We agree to furnish supplementally a copy of any omitted schedules or attachments to the Commission upon request.                                                                                                                         |
| 2.4(3)             | Asset Purchase Agreement dated May 28, 2002, by and among the Company and Cryomedical Sciences, Inc. Certain schedules and other attachments to this exhibit were omitted. We agree to furnish supplementally a copy of any omitted schedules or attachments to the Commission upon request.                                                                                                                        |
| 2.5(4)             | Partnership and Limited Liability Company Membership Interest Purchase Agreement, dated as of August 12, 2002, by and among Endocare, Inc. and U.S. Medical Development, Inc., U.S.M.D., Ltd. and U.S.M.D. I, L.L.C. Certain schedules and exhibits referenced in this exhibit have been omitted. We agree to furnish supplementally a copy of any omitted schedules or attachments to the Commission upon request. |
| 2.6(5)             | Amendment No. 1 to Partnership and Limited Liability Company Membership Interest Purchase Agreement, dated as of September 30, 2002, by and among Endocare, Inc. and U.S. Medical Development, Inc., U.S.M.D., Ltd. and U.S.M.D. I, L.L.C.                                                                                                                                                                          |
| 2.7(6)             | Agreement of Purchase and Sale, dated as of April 7, 2003, by and among American Medical Systems, Inc., the Company and Timm Medical Technologies, Inc.                                                                                                                                                                                                                                                             |
| 2.8(7)             | Asset Purchase and Technology License Agreement, dated as of April 29, 2003, by and between the Company and CryoCath Technologies Inc.                                                                                                                                                                                                                                                                              |
| 3.1(2)             | Certificate of Amendment of Restated Certificate of Incorporation of the Company.                                                                                                                                                                                                                                                                                                                                   |
| 3.2(2)             | Certificate of Designation of Series A Junior Participating Preferred Stock of the Company.                                                                                                                                                                                                                                                                                                                         |
| 3.3(2)             | Restated Certificate of Incorporation.                                                                                                                                                                                                                                                                                                                                                                              |
| 3.4(8)             | Amended and Restated Bylaws of the Company.                                                                                                                                                                                                                                                                                                                                                                         |
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