ENDOCARE INC
Form 10-Q
May 15, 2009

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2009

OR

o **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: 001-15063

Endocare, Inc.
(Exact name of Registrant as Specified in Its Charter)

DELAWARE	**33-0618093**
(State of Incorporation)	*(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 þ No o; (2) Yes þ No o

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

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

Large Accelerated Filer o	Accelerated Filer o	Non-Accelerated Filer o (Do not check if a smaller reporting company)	Smaller Reporting Company þ

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

The number of shares of the Registrant s common stock, par value $.001 per share, outstanding at March 31, 2009 was 11,818,617.

Endocare, Inc. and Subsidiary
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Part I. Financial Information

Part II. Other Information

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PART I FINANCIAL INFORMATION

Item 1. ***Condensed Consolidated Financial Statements***

ENDOCARE, INC. AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(In thousands, except per share data)

	Three Months Ended March 31,	
	2009	**2008**
Total revenues	$ 8,176	$ 8,143
Costs and expenses:		
Cost of revenues	2,335	2,505
Research and development	578	569
Selling and marketing	3,678	3,828
General and administrative	3,461	3,040
Total costs and expenses	10,052	9,942
Loss from operations	(1,876)	(1,799)
Interest income (expense), net	(91)	109
Net loss	$ (1,967)	$ (1,690)
Net loss per share basic and diluted	$ (0.16)	$ (0.14)
Weighted average shares of common stock outstanding	12,174	11,785

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

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ENDOCARE, INC. AND SUBSIDIARY
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)
(In thousands, except share and per share data)

	March 31, 2009	December 31, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	$ 2,643	$ 2,685
Accounts receivable less allowances for doubtful accounts and sales returns of $141 and $146 at March 31, 2009 and December 31, 2008, respectively	5,839	5,076
Inventories, net	2,343	2,559
Prepaid expenses and other current assets	457	518
Total current assets	11,282	10,838
Property and equipment, net	796	628
Intangibles, net	2,451	2,576
Investments and other assets	75	75
Total assets	$ 14,604	$ 14,117
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 3,771	$ 3,638
Accrued compensation	2,891	1,955
Other accrued liabilities	2,996	3,007
Loan payable	2,817	1,880
Obligations under capital lease, current portion	27	26
Total current liabilities	12,502	10,506
Deferred compensation	144	77
Obligations under capital lease less current portion	55	62
Stockholders equity:		
Preferred stock, $0.001 par value; 1,000,000 shares authorized; none issued and outstanding		
Common stock, $0.001 par value; 50,000,000 shares authorized; 11,818,617 and 11,811,451 issued and outstanding at March 31, 2009 and December 31, 2008, respectively	12	12
Additional paid-in capital	202,030	201,632
Accumulated deficit	(200,139)	(198,172)
Total stockholders equity	1,903	3,472
Total liabilities and stockholders equity	$ 14,604	$ 14,117

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

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ENDOCARE, INC. AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(In thousands, except per share data)

	Three Months Ended March 31,	
	2009	**2008**
Cash flows from operating activities:		
Net loss	$ (1,967)	$ (1,690)
Adjustments to reconcile net loss to net cash used in operating activities:		
Inventory reserve	18	
Depreciation and amortization	222	251
Stock-based compensation	414	728
Changes in operating assets and liabilities:		
Accounts receivable	(763)	(976)
Inventories	(66)	(183)
Prepaid expenses and other assets	61	73
Accounts payable	133	179
Accrued compensation	988	(1,010)
Other liabilities	(11)	8
Net cash used in operating activities	(971)	(2,620)
Cash flows from investing activities:		
Collection of notes receivable		1,560
Purchases of property and equipment	(2)	(7)
Net cash (used in) provided by investing activities	(2)	1,553
Cash flows from financing activities:		
Payments under capital lease obligation	(6)	(6)
Borrowings on line of credit	1,000	
Payments on line of credit	(63)	
Payroll tax on issuance of restricted stock		(124)
Net cash provided by (used in) financing activities	931	(130)
Net decrease in cash and cash equivalents	(42)	(1,197)
Cash and cash equivalents, beginning of period	2,685	7,712
Cash and cash equivalents, end of period	$ 2,643	$ 6,515
Non-cash activities:		
	$ 264	$ 115

Transfer of inventory to property and equipment for placement at customer sites		
Transfer of Cryocare Surgical Systems from property and equipment to inventory for sale	$	$ 54

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Tabular numbers in thousands, except per share data)
(Unaudited)

1. Organization and Operations

We are a medical device company focused on developing, manufacturing and selling cryoablation products which have the potential to assist physicians in improving and extending life by use in the treatment of cancer and other tumors. We were formed in 1990 as a research and development division of Medstone International, Inc. (Medstone), a manufacturer of shockwave lithotripsy equipment for the treatment of kidney stones. Following our incorporation under the laws of the state of Delaware in 1994, we became an independent, publicly-owned corporation upon Medstone s distribution of our stock to the existing stockholders on January 1, 1996.

Proposed Merger and Financing

On November 10, 2008, Endocare and Galil Medical, Ltd. (Galil), a privately held Israeli cryoablation company, entered into an Agreement and Plan of Merger (the Merger Agreement). Under the Merger Agreement, Orange Acquisitions Ltd., a newly formed wholly owned subsidiary of Endocare in Israel, will merge with and into Galil (the Merger), with Galil continuing after the Merger as the surviving company and a wholly owned subsidiary of Endocare. Upon the terms and subject to the conditions set forth in the Merger Agreement, at the effective time of the Merger, each issued and outstanding share of Galil will be converted into the right to receive shares of our common stock.

At the effective time of the Merger, it is expected that 11,199,195 shares of Endocare common stock will be issued in the Merger and Endocare will assume the outstanding stock options of Galil. The exact conversion ratio cannot be calculated until immediately prior to the effective time of the Merger, but it is expected that approximately 33 ordinary shares of Galil will be converted into one share of Endocare common stock. Immediately following the effective time of the Merger and attributing ownership to Galil s shareholders of shares to be deposited into the escrow account (the Escrow Shares), Galil s shareholders will own approximately 48.0%, and Endocare s stockholders will own approximately 52.0%, of Endocare s common stock, without giving effect to the shares issuable pursuant to the concurrent Financing described below. The Merger will have no effect on the number of shares of common stock of Endocare owned by existing Endocare stockholders. Subject to receipt of regulatory approvals, including the closing of the pending investigation by the Federal Trade Commission (the FTC), and approvals by Endocare stockholders and Galil shareholders, we are seeking to close the Merger in the second quarter of 2009.

The Merger Agreement terminates pursuant to its terms if the Merger has not occurred on or prior to June 30, 2009, unless the parties agree otherwise. The Merger Agreement contains certain other termination rights for both Endocare and Galil, including each party s right to terminate the Merger Agreement in the event the other party s available cash drops below $1.0 million for more than ten business days. Upon termination of the Merger Agreement for specified breaches and certain similar circumstances, either party may be required to pay the other party a termination fee of $900,000 and to reimburse such party for expenses incurred in connection with the Merger, up to a maximum of $850,000. In addition, upon a termination of the Merger Agreement that does not trigger an obligation of a party to pay a termination fee in some circumstances, a party may nonetheless be required to reimburse the other party for expenses incurred in connection with the Merger, up to a maximum of $850,000.

Concurrent with the execution of the Merger Agreement, Endocare and certain existing institutional accredited stockholders of Endocare and Galil entered into a Stock Purchase Agreement, relating to the private placement by Endocare of 16,250,000 shares of Endocare common stock at a purchase price of $1.00 per share (the Financing). The offering gross proceeds to Endocare from the Financing are expected to be $16.3 million. The closing of the Financing is subject to the concurrent closing of the Merger and certain other conditions, including the sale of shares in the Financing with a minimum aggregate purchase price of $12 million and that Endocare s common stock remains listed on the NASDAQ Capital Market or the Over-The-Counter Bulletin Board. The issuance of common shares pursuant to the Merger Agreement and the Purchase Agreement is also subject to approval by our stockholders.

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Upon consummation of the Merger and the Financing, and attributing ownership to Galil s shareholders of the Escrow Shares, existing Endocare stockholders will own approximately 38.5% of our outstanding common stock and the shareholders of Galil will own approximately 61.5% of our outstanding common stock. As a result, the Merger will be accounted for as a reverse acquisition and equity recapitalization in accordance with U.S. generally accepted accounting principles. Under this method of accounting, after completion of the Merger and the Financing, Endocare will be treated as the acquired company for financial accounting and reporting purposes, and the combined entity s results of operations prior to completion of the Merger will be those of Galil. We are obligated to pay a transaction fee of $800,000 and a percentage of the Financing proceeds (estimated to be approximately $265,000) to our investment banker upon the closing of the Merger and Financing. An opinion fee of $450,000, which we previously paid, will be credited toward the $800,000 transaction fee. The Merger will be accounted for under the Statement of Financial Accounting Standards (SFAS) No. 141(R), *Business Combination*. Purchase consideration will be measured based on the fair value of equity instruments exchanged on the closing date. Consideration paid in excess of net tangible and intangible assets acquired will be recorded as goodwill. If the purchase consideration is less than the fair value of the net assets acquired, the difference will be recorded as a gain on the acquisition date.

We anticipate that the Merger will enhance shareholder value and solidify the long-term prospects of our cryoablation technology in the market place. Combining the two companies enhances our competitive position by providing complementary geographic markets resulting in larger global reach, a greater customer base, a complementary technology and patent portfolio as well as greater financial resources for promoting cryoablation demand and awareness against more established treatment options and for developing new applications for our proprietary technologies. Through consolidation of duplicate facilities, functions and overhead, Endocare and Galil also expect to achieve greater economies of scale and near-term and long-term savings by eliminating duplicative manufacturing, selling, marketing and administrative costs, redundant regulatory programs and the costs for separate clinical trials and studies. However, there is no assurance that the operations of the two companies will be successfully integrated or that the anticipated growth and savings will be realized.

HealthTronics Proposal

On April 9, 2009, we received a written proposal from HealthTronics, Inc. (HealthTronics), offering to purchase all of Endocare s outstanding common stock for $1.25 per share, with Endocare stockholders having the ability to elect to receive either cash or HealthTronics common stock as consideration (the HealthTronics Proposal). The proposal is subject to negotiation of a definitive written agreement and due diligence. Our Board of Directors has determined that the HealthTronics Proposal could reasonably be expected to lead to a Superior Proposal as defined in the Merger Agreement and is in the process of further evaluating the HealthTronics Proposal, including conducting due diligence and collecting other information appropriate for such evaluation. Our Board of Directors has not determined that the HealthTronics Proposal is in fact a Superior Proposal.

2. Basis of Presentation

Following the rules and regulations of the Securities and Exchange Commission (SEC), we have omitted footnote disclosures in this report that would substantially duplicate the disclosures contained in our annual audited financial statements. The accompanying condensed consolidated financial statements should be read together with the consolidated financial statements and the notes thereto included in our Annual Report on Form 10-K, filed with the SEC on March 30, 2009.

The accompanying condensed consolidated financial statements 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.

3. Recent Operating Results and Liquidity

Since inception, we have incurred losses from operations and have reported negative cash flows. As of March 31, 2009 we had $2.6 million in cash and cash equivalents, all of which is borrowed under our line of credit and is payable on May 27, 2009 when the credit line is scheduled to expire. We are in discussions with the lender to obtain more permanent long-term financing, although such financing may not be available or available on terms acceptable to us.

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Net cash used in operations were $1.0 million and $2.6 million for the three months ended March 31, 2009 and 2008, respectively. We do not expect to reach positive adjusted Earnings Before Interest, Tax, Depreciation and Amortization (EBITDA) on an annual basis in 2009, both as a stand-alone company and as a combined company after the proposed Merger discussed in Note 1, and we expect to continue to generate losses from operations for the foreseeable future. These losses have resulted in part from our continued investments to gain acceptance of our technology and investment in initiatives that we believe should ultimately result in cost reductions. In addition to working capital needs for our operations and growth initiatives, we incurred significant expenditures under indemnification obligations for our former officers and directors through the third quarter of 2008 and have large outstanding state and local tax liabilities as described below. In addition, we have incurred legal, accounting and other fees related to the proposed Merger and Financing.

We expect to use existing cash reserves, working capital through the sale of our products and the proceeds from borrowings on our line of credit to fund our operations until we complete the Merger and Financing. We believe the net proceeds from the Financing combined with expected expense reductions from eliminating duplicate or redundant facilities, infrastructure and functions will be adequate to enable the post-merger combined company to reach positive adjusted EBITDA.

Although we have incurred significant payments under our indemnification agreements with certain former officers and directors in the past, we have no continuing obligations in the future. In August and October 2008, we entered into agreements with our former CFO and former CEO, respectively, who were under investigation by the SEC and the Department of Justice (DOJ), pursuant to which their indemnification agreements were terminated in exchange for our waiver of certain severance and legal fee reimbursement rights. As a result of these new agreements, we are no longer obligated to pay any future legal costs for these former officers. These former officers entered into plea agreements with the DOJ to resolve the criminal cases against them late in 2008. During 2008, we incurred expenses of $1.9 million relating to legal fees of former officers and former directors, and recorded insurance recoveries of $0.1 million. We have exhausted the remaining reimbursement available under this insurance coverage. See Note 10 *Commitments and Contingencies* for additional discussion.

We face large cash expenditures in the future related to past due state and local taxes, primarily sales and use tax obligations, which we estimate to be approximately $2.1 million. The amount was fully accrued as of March 31, 2009. We are in the process of negotiating resolutions of the past due state and local tax obligations with the applicable tax authorities. However, there is no assurance that these obligations will be reduced as a result of the negotiations or that we will be allowed to pay the amounts due over an extended period of time.

During the quarter ended March 31, 2009 and the year ended December 31, 2008, we incurred $1.3 million and $2.4 million respectively, in relation to potential strategic transactions including the proposed Merger. We estimate that $1.1 million in additional legal and accounting expenses will be incurred in 2009 to complete the Merger and Financing and we will pay total transaction fees currently estimated at approximately $1.1 million from the Financing proceeds to our investment banker at closing. Expenditures related to the Merger are recorded as general and administrative expenses as incurred in accordance with Statement of Financial Accounting Standards (SFAS) No. 141(R), *Business Combinations*. Fees related to the Financing and share issuance will be recorded as a reduction of paid in capital. Consummation of the Merger is expected to continue to require a significant use of cash including post-closing integration costs, or, if the Merger is not consummated, any continued exploration of other strategic alternatives.

We have historically financed our operations and growth through borrowings and equity financings. Our cash needs are not entirely predictable. If the Merger and Financing are consummated, the net proceeds of the Financing will be used to finance the operations, costs of integration and cash flow needs of the combined company. The expected gross proceeds to Endocare of the proposed Financing are expected to be approximately $16.3 million. The closing of the Financing is subject to the concurrent closing of the proposed Merger and certain other conditions including the sale of shares with a minimum aggregate purchase price of $12.0 million. In the event that our available cash drops below $1.0 million for more than ten business days, Galil has the right to terminate the Merger Agreement.

If additional cash is required before we complete the Merger and Financing, we may access the remaining funds available under our $4.0 million bank credit facility. The funds we can borrow are based on eligible trade

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receivables and inventory as defined. The credit facility includes a subjective acceleration clause and a requirement to maintain a lock box with the lender, the proceeds from which will be applied to reduce the outstanding borrowings upon our default or if other conditions are met. During the first quarter of 2009, we borrowed an additional $1 million under our credit facility, bringing the total amount currently outstanding under the credit facility to $2.8 million. As of March 31, 2009, there was $1.2 million available for additional borrowing under the credit facility. Our credit facility contains a minimum tangible net worth covenant measured on a monthly basis. The future availability of funds from our bank credit facility is subject to many conditions, including the subjective acceleration clause and other provisions that are predicated on events not within our control. We cannot access the bank credit facility if we fail to comply with all covenants and borrowing conditions. If a waiver is not granted, the bank can accelerate the outstanding indebtedness under the credit facility and terminate the credit facility. Under the subjective acceleration clause, the bank can accelerate payment on all outstanding borrowings and cease to make further advances to us in the event of default or if the bank determines in its judgment that a material adverse change has occurred or will occur.

We were not in compliance with the minimum tangible net worth covenant as of December 31, 2008 and January 31, 2009, and received a waiver from the bank with respect to this noncompliance on February 26, 2009. The waiver also redefines the minimum tangible net worth requirement and provides new lower net worth requirements for February through April 2009. There is no assurance that we will be able to comply with all borrowing requirements and covenants in future periods, that we can obtain a waiver if additional events of default occur or that the lender will not exercise the subjective acceleration clause. As of March 31, 2009, we were in compliance with all borrowing and covenant requirements.

There is no assurance that the Merger and Financing will occur and we cannot guarantee the availability of our existing capital resources or that they will be sufficient to fund our ongoing operations to the point where our operations will generate positive cash flows on a consistent basis. We will continue to assess the adequacy of our capital resources and may need to use existing and new sources of capital to finance operations and the growth of the business. If the Merger and Financing are not consummated, Endocare, as a stand-alone company, expects that it will need to raise additional capital during 2009 to fund its ongoing operations. Should such financing be unavailable or prohibitively expensive when we require it, the consequences would have a material adverse effect on our business, financial condition, results of operations and cash flows.

Our continuing losses, cashflow deficits and obligations, the scheduled expiration of our credit facility in May 2009, along with the contingencies in our funding sources, together raise substantial doubt about our ability to continue as a going concern. The accompanying financial statements have been prepared assuming that we will continue as a going concern and do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result from the outcome of this uncertainty.

4. Private Placement of Common Stock and Warrants

March 2005 Private Placement

On March 11, 2005, we completed a private placement of 1,878,448 shares of our common stock and detachable warrants to purchase 1,314,892 common shares at an offering price of $8.31 per share, for aggregate gross proceeds of $15.6 million. Transaction costs were $1.0 million, resulting in net proceeds of $14.6 million. Of the total warrants, 657,446 had an initial exercise price of $10.50 (Series A warrants) per share and 657,446 had an initial exercise price of $12.00 (Series B warrants) per share. The expiration date of the warrants is May 1, 2010.

The warrants have an anti-dilution clause that is triggered upon issuance of a certain number of shares of our common stock that reduces the effective exercise price of the warrants to preserve the ownership of the warrant holders. As a result of our May 2007 private placement and the issuance of shares to Fusion Capital through November 6, 2008, the exercise price of the Series A Warrants decreased to $10.02 to effectively provide holders the right to purchase an additional 31,667 shares and the exercise price of the Series B Warrants decreased to $11.37 to effectively provide holders the right to purchase an additional 37,191 shares.

The warrants initially are exercisable at any time during their term for cash only. The warrants may be exercised on a cashless exercise basis in limited circumstances after the first anniversary of the closing date if there is not an

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effective registration statement covering the resale of the shares underlying the warrants. Each warrant is callable by us at a price of $0.01 per share underlying such warrant if our stock trades above certain dollar per share thresholds ($19.50 for the Series A warrants and $22.50 for Series B warrants) for 20 consecutive days commencing on any date after the effectiveness of the registration statement, provided that (a) we provide 30-day advanced written notice (Notice Period), (b) we simultaneously call all warrants on the same terms and (c) all common shares issuable are registered. Holders may exercise their warrants during the Notice Period and warrants which remain unexercised will be redeemed at $0.01 per share.

Under the registration rights agreement, we could incur liquidated damages in the future (equal to one percent of the aggregate purchase price paid by each affected holder per month) if holders are unable to make sales under the registration statement (for example, if we fail to keep the registration statement current as required by SEC rules or if future amendments to the registration statement are not declared effective in a timely manner). The registration obligation remains outstanding until the earlier of the date on which all shares issuable upon exercise of the warrants have been issued and resold by the holders of the warrants or the date on which all such shares can be resold by the holders without registration. Accruals for liquidated damages, if any, will be recorded when they are probable and reasonably estimable.

We adopted EITF Issue No. 07-5, *Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity s Own Stock,* as of January 1, 2009. The adoption of EITF 07-5 requires the March 2005 Private Placement warrants to be classified as a derivative liability until the earlier of the date the warrants are exercised or have expired. Additionally, we must remeasure the warrants fair value each quarter in connection with changes in the underlying stock price and other assumptions, with the change in value recorded as interest expense. The adoption of EITF Issue No. 07-5 did not have a significant impact on our financial condition, results of operations or cash flows.

5. Bank Line of Credit

As described above in Note 3 *Recent Operating Results and Liquidity,* on October 26, 2005, we entered into a one-year credit facility with Silicon Valley Bank (the Lender), which provided up to $4.0 million in borrowings for working capital purposes in the form of a revolving line of credit and term loans (not to exceed $500,000). On February 26, 2009, the agreement was extended to expire on May 27, 2009. We are in discussions with the lender to obtain more permanent long-term financing. However, such financing may not be available or available on terms acceptable to us.

The credit facility permits borrowings up to the lesser of $4.0 million or amounts available under a borrowing base formula based on eligible accounts receivable and inventory, but availability of funds is ultimately subject to the good faith business judgment of the Lender. As amended, the borrowing base is (i) 85 percent of eligible accounts receivable, plus (ii) the lesser of 30 percent of the value of eligible inventory or $500,000. Borrowings are secured by all of our assets, including all accounts receivable collections which are held in trust for the Lender. Interest is payable monthly at prime rate plus 1.5 percent. The agreement requires a one-time commitment fee of $40,000 paid on the effective date and an annual facility fee equal to 0.5 percent of the unused portion of the facility. A termination fee will also be assessed if the credit facility is terminated prior to expiration. As of March 31, 2009 and December 31, 2008, there was $2.8 million and $1.9 million respectively, outstanding on the line of credit. The weighted average interest rate at March 31, 2009 and December 31, 2008 was $4.90% and 6.60% respectively. Additional paydowns net of borrowings since March 31, 2009, total $0.4 million. As of May 14, 2009 the outstanding balance on the line of credit was $2.4 million.

As a condition to each advance under the credit facility, all representations and warranties by us must be materially true and no event of default must have occurred or be continuing. In addition, the Lender, in its good faith business judgment, must determine that no material adverse change has occurred. A material adverse change occurs when there is a material impairment in the priority of the Lender s lien in the collateral or its value, a material adverse change in our business, operations or condition, a material impairment of the prospect of repayment or if the Lender determines, in its good faith reasonable judgment, that there is a reasonable likelihood that we will fail to comply with one or more financial covenant in the next financial reporting period.

The agreement governing the credit facility contains various financial and operating covenants that impose limitations on our ability, among other things, to incur additional indebtedness, merge or consolidate, sell assets

except in the ordinary course of business, make certain investments, enter into leases and pay dividends without the consent of the Lender. The credit facility also includes a subjective acceleration clause and a requirement to maintain a lock box with the Lender to which all collections are deposited. Under the subjective acceleration clause,

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the Lender may declare default and terminate the credit facility if it determines that a material adverse charge has occurred. If the aggregate outstanding advances plus reserves placed by the Lender against the loan availability exceeds 50 percent of the receivable borrowing base component as defined, or if a default occurs, all current and future lock box proceeds will be applied against the outstanding borrowings. The credit facility also contains cross-default provisions and a minimum tangible net worth requirement measured on a monthly basis. Tangible net worth must be equal to or greater than negative $2.0 million as of March 31, 2009.

As of December 31, 2008 and January 31, 2009, we were not in compliance with the minimum net worth covenant. On February 26, 2009, we received a waiver from the bank with respect to this noncompliance. The amendment and waiver revises the definition of tangible net worth as a Base Amount plus 25% of all consideration received after January 1, 2009 from equity issuances and the principal amount of subordinated debt, plus 25% of the Company s positive consolidated net income in each quarter ending after January 1, 2009. The amendment also provides new lower Base Amounts for February, March and April 2009. However, since the outstanding advances exceed 50 percent of the receivable borrowing base referred to above, beginning in March 2009, our lock-box proceeds have been applied daily to reduce the outstanding advances and we re-borrow the amount subject to the lender s approval.

6. Collection of Notes Receivable

In February 2008, we collected a $1.4 million note receivable and $0.1 million in related interest income from Plethora Solutions Holdings plc (Plethora), who purchased our former subsidiary Timm Medical Technology, Inc. in February 2006. In anticipation of a potential accelerated settlement of the note in exchange for a discount, we had recorded a $0.3 million reserve on the note balance in the fourth quarter of 2006 and ceased accruing interest income. During the three months ended September 30, 2007, we reversed the $0.3 million allowance and reinstated the note to its face value and recorded $0.1 million in interest income previously suspended. In February 2008, the note and interest income was collected in full.

7. Capital Stock and Net Loss Per Share

Basic net loss per share is computed by dividing net loss by the weighted average number of common shares outstanding for the respective periods. Basic earnings per share also include contingently issuable shares (such as fully vested deferred and restricted stock units) as of the date all necessary conditions for issuance have been met. Diluted 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, warrants, deferred stock units and restricted stock units that were outstanding during the respective periods presented. For periods when we reported a net loss, these potentially dilutive common shares were excluded from the diluted loss per share calculation because they were anti-dilutive. The total number of shares excluded from the calculation of diluted net loss per share, prior to application of the treasury stock method for options and warrants was 3.2 million and 3.9 million for the three months ended March 31, 2009 and 2008, respectively.

8. Stock-Based Compensation

Our equity incentive programs include stock options, restricted stock units and deferred stock units. Some awards vest based on continuous service while others vest based on performance conditions, such as profitability and sales goals. We account for equity awards in accordance with SFAS No. 123 (revised), *Share-Based Payment* (SFAS No. 123R), which requires measurement and recognition of compensation expense for all share-based awards made to employees and directors.

Under SFAS No. 123R, the fair value of share-based awards is estimated at grant date using an option pricing model, and the portion that is ultimately expected to vest is recognized as compensation cost over the requisite service period. For awards that vest based on continuous service, we record compensation expense ratably over the service period from the date of grant. For performance-based awards, we begin recording compensation expense over the remaining service period when we determine that achievement is probable. Change in estimates as to the probability of vesting is recorded through cumulative catch-up adjustments when the assessment is made. Change in the estimated implicit service period is recorded prospectively over the adjusted vesting period. Since share-based compensation under SFAS No. 123R is recognized only for those awards that are ultimately expected to vest, we

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have applied an estimated forfeiture rate to unvested awards for the purpose of calculating compensation cost. These estimates will be revised, if necessary, in future periods if actual forfeitures differ from the estimates. Changes in forfeiture estimates impact compensation cost in the period in which the change in estimate occurs. We use the Black-Scholes option-pricing model to estimate the fair value of share-based awards. The determination of fair value using the Black-Scholes option-pricing model is affected by our stock price as well as assumptions regarding a number of complex and subjective variables, including expected stock price volatility, risk-free interest rate, expected dividends and projected employee stock option exercise behaviors.

Net stock-based compensation expense recorded in the three months ended March 31, 2009 and 2008 was $0.4 million and $0.7 million, respectively. These amounts are primarily included in selling and marketing and general and administrative expenses.

9. Inventories

Inventories, consisting of raw materials, work-in-process and finished goods, are stated at the lower of cost or market, with cost determined by the first-in, first-out method. Reserves for slow-moving and obsolete inventories are provided based on historical experience and product demand. We evaluate the adequacy of these reserves quarterly.

The following is a summary of inventories:

	March 31, 2009	December 31, 2008
Raw materials	$ 1,683	$ 1,831
Work in process	286	119
Finished goods	879	1,096
Total inventories	2,848	3,046
Less: inventory reserve	(505)	(487)
Inventories, net	$ 2,343	$ 2,559

10. Commitments and Contingencies

Governmental Investigations and Legal Proceedings

On August 9, 2006, the SEC filed civil fraud charges in federal district court against our former CEO and CFO related to our historical financial reporting issues and related matters. On April 9, 2007, these two former officers were indicted by a federal grant jury for multiple counts of felony. These charges arose from investigations begun by the SEC and DOJ in January 2003 of the Company and certain of our former officers and directors and one current employee. Under a prior agreement, the former CEO and the former CFO each agreed to repay us severance and related amounts they received upon separation in 2003 ($750,000 in the case of the former CEO and approximately $666,000 in the case of the former CFO) upon either (i) his conviction in a court of law, or entering into a plea of guilty or no contest to, any crime directly relating to his activities on behalf of Endocare during his employment, or (ii) successful prosecution of an enforcement action by the SEC against him.

In August and October 2008, we entered into agreements with the former CFO and former CEO, respectively, pursuant to which their indemnification agreements were terminated in exchange for our waiver of the severance and legal fee reimbursement rights. As a result of these new agreements, we are no longer obligated to pay any future legal costs for these former officers. The agreement with the former CEO in October 2008 also provides that our obligation to pay for his legal costs incurred in August 2008 and September 2008 is limited to the amount, if any, that we receive from the former CEO as restitution. Under this provision, we received $0.5 million from our former CEO as restitution payments in October, 2008 and applied the funds to his legal costs in August and September 2008. These former officers have entered into plea agreements with the DOJ to resolve the criminal cases against them.

The United States Federal Trade Commission (FTC) has opened an investigation into whether the proposed Merger with Galil violates Section 7 of the Clayton Act, as amended, 15 U.S.C. § 18, or Section 5 of the FTC Act, as

amended, 15 U.S.C. § 48. The parties are cooperating fully with the FTC s investigation and are in the process of

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providing the FTC with information and materials. We cannot provide any assurance that the FTC s investigation will not delay or prevent the consummation of the Merger.

Other Litigation

In addition, in the normal course of business, we are subject to various other legal matters, which we believe will not individually or collectively have a material adverse effect on our consolidated financial condition, results of operations or cash flows. However, the results of litigation and claims cannot be predicted with certainty, and we cannot provide assurance that the outcome of various legal matters will not have a material adverse effect on our consolidated financial condition, results of operations or cash flows.

11. Income Taxes

We reported no income tax expense during the three months ended March 31, 2009 and December 31, 2008 due to our operating losses. Due to our history of operating losses, management has determined that it is more likely than not that our deferred tax assets will not be realized through future earnings. Accordingly, valuation allowances were recorded to fully reserve the deferred tax assets as of March 31, 2009 and December 31, 2008.

In accordance with the provisions of Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, *an interpretation of SFAS No. 109*, *Accounting for Income Taxes* (FIN 48), we had no unrecognized tax benefits as of March 31, 2009 and do not expect a material change in the next 12 months.

We recognize interest and penalties related to uncertain tax positions, if any, in income tax expense. The tax years 2005 through 2008 remain open to examination by the major taxing jurisdictions to which we are subject.

12. Fair Value Measurement

We adopted the provisions of SFAS No. 157, *Fair Value Measurements*, effective January 1, 2008, for our financial assets and liabilities. Under this standard, fair value is defined as the exchange price that would be received to sell an asset or paid to transfer a liability (i.e., the exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants at the measurement date. In February 2008, the FASB issued FSP No. 157-2, *Effective Date of FASB Statement No. 157,* which delayed the effective date of SFAS No. 157 until January 1, 2009, with respect to the fair value measurement requirements for non-financial assets and liabilities that are not re-measured on a recurring basis (at least annually). We adopted the provisions of SFAS No. 157 with respect to non-financial assets and liabilities that are not re-measured on a recurring basis on January 1, 2009. The adoption did not have a material impact on our condensed consolidated financial statements.

SFAS No. 157 establishes a three-level hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability based on market data obtained from sources independent of us. Unobservable inputs are inputs that reflect our assumptions about the inputs that market participants would use in pricing the asset or liability and are developed based on the best information available in the circumstances.

The fair value hierarchy is broken down into three levels based on the source of inputs. In general, fair values determined by Level 1 inputs utilize quoted prices (unadjusted) in active markets for identical assets or liabilities that we have the ability to access. We classify our money market funds as Level 1 assets. As of March 31, 2009, we had $1.1 million in money market securities included in cash and cash equivalents. Fair values determined by Level 2 inputs are based on quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active and models for which all significant inputs are observable or can be corroborated, either directly or indirectly by observable market data. We classify our March 2005 Private Placement warrants as Level 2 liabilities. As of January 1, 2009 and March 31, 2009, the fair value of our outstanding warrants was not significant. Level 3 inputs are unobservable inputs for the asset or liability, and include situations where there is little, if any, market activity for the asset or liability. These include certain pricing models, discounted cash flow methodologies and similar techniques that use significant unobservable inputs. We did not hold any Level 3 instruments at March 31, 2009 and December 31, 2008.

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On January 1, 2008, we also adopted the provision of SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS No. 159), which allows an entity to voluntarily choose to measure many financial instruments and certain other items at fair value. Entities that choose the fair value option will recognize the unrealized gains and losses on items for which the fair value option was elected in earnings at each subsequent reporting date. We have chosen not to elect the fair value option for any items that are not already required to be measured at fair value in accordance with generally accepted accounting principles (GAAP).

13. Results of Operations

Revenues and cost of revenues related to the following products and services for the periods ended March 31, 2009 and 2008 are as follows:

	Three Months Ended March 31,	
	2009	**2008**
Revenues:		
Cryoablation disposable products	$ 5,914	$ 5,916
Cryocare Surgical Systems	393	433
	6,307	6,349
Cryoablation procedure fees	1,745	1,690
Cardiac royalties	130	113
Other	(6)	(9)
	$ 8,176	$ 8,143
Costs of Revenues:		
Cryoablation disposable products and procedure fees	$ 2,294	$ 2,359
Cryocare Surgical Systems	41	146
	$ 2,335	$ 2,505

Cost of revenues for cryoablation disposable product sales and procedure fees are combined for reporting purposes. Sales of cryoablation disposable products and procedure fees both incorporate similar inventory when sold and we do not separately track the cost of disposals sold directly to customers and those consumed in cryoablation procedures. Cryoablation procedure services are provided to medical facilities upon request to facilitate the overall delivery of our technology into the marketplace.

14. Subsequent Events

In April 1999, we adopted a stockholder rights plan (the Plan) in which preferred stock purchase rights were distributed as a dividend at the rate of one right for each share of common stock held as of the close of business on April 15, 1999. The rights are designed to guard against partial tender offers and other abusive and coercive tactics that might be used in an attempt to gain control of us or to deprive our stockholders of their interest in the long-term value of Endocare. The rights, under the original plan, would be exercisable only if a person or group acquired 15 percent or more of Endocare s common stock (subject to certain exceptions stated in the Plan) or announced a tender offer the consummation of which would result in ownership by a person or group of 15 percent or more of our common stock. At any time on or prior to the close of business on the first date of a public announcement that a person or group had acquired beneficial ownership of 15 percent or more of our common stock (subject to certain exceptions stated in the Plan), the rights would be redeemable for $0.01 per right at the option of the Board of Directors. The rights would expire at the close of business on April 15, 2009 (the Final Expiration Date), unless the Final Expiration Date was extended or unless we redeemed or exchanged the rights earlier.

On March 26, 2009, we entered into an amendment to the Plan. The rights, as amended, will be exercisable only if a person or group acquires 20 percent or more of Endocare s common stock (subject to certain exceptions stated in the Plan) or announces a tender offer the consummation of which would result in ownership by a person or group of 20 percent or more of our common stock. At any time on or prior to the close of business on the first date of a public announcement that a person or group has acquired beneficial ownership of 20 percent or more of our common stock

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(subject to certain exceptions stated in the Plan), the rights are redeemable for $0.03 per right at the option of the Board of Directors. The rights, as amended, will expire at the close of business on March 31, 2011 (the Final Expiration Date), unless the Final Expiration Date is extended or unless we redeem or exchange the rights earlier.

On April 6, 2009, Terrance A. Noonan resigned from our Board of Directors. Mr. Noonan had previously taken a leave of absence from our Board of Directors on March 19, 2009 due to health reasons. Our Board of Directors appointed David L. Goldsmith as interim Chairman.

On April 16, 2009 we adopted an amendment to extend the post-termination exercise periods of all of the stock options previously granted by us to Terrance A. Noonan, including stock options granted to Mr. Noonan in his capacity as a non-employee director and in his capacity as Interim CEO and President. The post-termination exercise periods are March 19, 2012 for stock options granted in his capacity as Interim CEO and President, and April 6, 2012 for stock options granted in his capacity as a non-employee director.

On April 9, 2009, we received the HealthTronics Proposal, offering to purchase all of Endocare s outstanding common stock for $1.25 per share, with Endocare stockholders having the ability to elect to receive either cash or HealthTronics common stock as consideration. The proposal is subject to negotiations of a definitive agreement and due diligence.

On May 5, 2009, the SEC declared effective our Registration Statement on Form S-4 filed on January 23, 2009 and subsequent filed amendments. In connection with the proposed merger with Galil Medical Ltd., we had filed with the SEC this Registration Statement and subsequent amendments, which include a proxy statement/prospectus of Endocare, and other relevant documents concerning the transaction.

Consistent with the terms of our credit facility agreement, since the outstanding advances exceed 50 percent of the receivable borrowing base, beginning on March 30, 2009, our lock-box proceeds have been applied daily to reduce the outstanding advances and we re-borrow the amount subject to the lender s approval. Additional paydowns net of borrowings since March 31, 2009, total $0.4 million. As of May 14, 2009 the outstanding balance on the line of credit was $2.4 million.

Our common stock is currently listed on the NASDAQ Capital Market. In order to maintain that listing, we must satisfy minimum financial and other listing requirements. NASDAQ Marketplace Rule 5550(b)(1) requires minimum stockholders equity of $2.5 million for continued listing on the NASDAQ Capital Market. As of March 31, 2009, our total stockholders equity was $1.9 million. We anticipate receiving notification from NASDAQ of our failure to comply with NASDAQ Marketplace Rule 5550(b)(1). Within 15 days following such notification we will be required to submit a plan of compliance to demonstrate how we intend to remedy this deficiency within the following 30-60 days and to sustain compliance for the next six to 12 months.

15. Recent Accounting Pronouncements

In December 2007, the FASB ratified EITF Issue No. 07-1, *Accounting for Collaborative Arrangements.* EITF No. 07-1 provides guidance regarding financial statement presentation and disclosure of collaborative arrangements to jointly develop, manufacture, distribute and market a product whereby the collaborators will share, based on contractually defined calculations, the profits or losses from the associated activities. The consensus requires collaborators in such an arrangement to present the result of activities for which they act as the principal on a gross basis and report any payments received from (made to) other collaborators based on other applicable GAAP or, in the absence of other applicable GAAP, based on analogy to authoritative accounting literature or a reasonable, rational and consistently applied accounting policy election. EITF Issue No. 07-1 is effective for fiscal years beginning after December 31, 2008, which will be our fiscal year 2009, and will be applied as a change in accounting principle retrospectively for all collaborative agreements existing as of the effective date. EITF No. 07-01 is currently effective and its adoption did not have a significant impact on our financial condition, results of operations or cash flows.

In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations* and SFAS No. 160, *Accounting and Reporting of Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51.* These standards will significantly change the accounting and reporting for business combination transactions and noncontrolling (minority) interests in consolidated financial statements. SFAS No. 141(R) requires companies to

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recognize all the assets acquired and liabilities assumed in a business combination and establishes the acquisition-date fair value as the measurement objective, including capitalizing at the acquisition date the fair value of acquired in-process research and development, and re-measuring and writing down these assets, if necessary, in subsequent periods during their development. SFAS No. 141(R) will also impact the determination of acquisition-date fair value of consideration paid in a business combination (including contingent consideration), exclude transaction costs from acquisition accounting, and change accounting practices for acquired contingencies, acquisition-related restructuring costs, indemnification assets, and tax benefits. SFAS No. 141(R) and SFAS No. 160 will be applied prospectively for business combinations that occur on or after January 1, 2009, except that presentation and disclosure requirements of SFAS No. 160 regarding noncontrolling interests shall be applied retrospectively. We adopted SFAS No. 141(R) and SFAS No. 160 as of January 1, 2009, as required. At the effective time of the Merger, the accounting and business combination transaction will be recorded in accordance with both pronouncements. As of March 31, 2009, we have incurred $1.3 million related to legal and financial advisory expenses to evaluate potential strategic opportunities including the Merger. These expenditures were recorded as general and administrative expenses as incurred in accordance with SFAS No. 141(R). Consummation of the Merger is subject to certain closing conditions, including, among other things, approval by Endocare stockholders and those of Galil and continued listing of Endocare common stock on the NASDAQ Capital Market.

In April 2008, the FASB issued FSP FAS No. 142-3, which amends the factors that must be considered in developing renewal or extension assumptions used to determine the useful life over which the cost of a recognized intangible asset is amortized under SFAS No. 142, *Goodwill and Other Intangible Assets*. The FSP requires an entity to consider its own assumptions about renewal or extension of the term of the arrangement, consistent with its expected use of the asset, and is an attempt to improve consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141(R), *Business Combinations*. The FSP is effective for fiscal years beginning after December 15, 2008, and the guidance for determining the useful life of a recognized intangible asset must be applied prospectively to intangible assets acquired after the effective date. FSP FAS No. 142-3 is currently effective and its adoption did not have a significant impact on our financial condition, results of operations or cash flows. We will be applying FSP FAS No. 142-3 on an ongoing basis to intangible assets acquired in our merger with Galil that we are seeking to close in the second quarter of 2009.

In June 2008, the FASB ratified EITF Issue No. 07-5, *Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity s Own Stock*. EITF No. 07-5 provides guidance regarding financial statement presentation and disclosure of equity-linked financial instruments as well as guidance for bifurcation as derivatives. This EITF must be applied to determine whether freestanding equity derivatives (e.g. warrants, and forward contracts) or embedded equity derivatives features (e.g. conversion options) qualify for exclusion under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* specifically paragraph 11 (a) contracts issued or held by that reporting entity that are both (1) indexed to its own stock and (2) classified in stockholder s equity in its statement of financial position. EITF Issue No. 07-5 is effective for fiscal years beginning after December 15, 2008, which is our fiscal year 2009, and is applied as a change in accounting principle retrospective for all outstanding instruments as of the date of adoption. We adopted EITF Issue No. 07-5 as of January 1, 2009 and its adoption requires that the March 2005 Private Placement warrants be classified as a derivative liability until the earlier of the date the warrants are exercised or have expired. Additionally, we must remeasure the warrants fair value each quarter in connection with changes in the underlying stock price and other assumptions, with the change in value recorded as interest expense. Concurrently with the adoption of EITF 07-5, we also adopted the guidance in FASB Staff Position APB 14-1, *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement).* EITF 07-5 and FSP APB 14-1 are currently effective and their adoption did not have a significant impact on our financial condition, results of operations or cash flows.

Other recent accounting pronouncements issued by the FASB (including its Emerging Issues Task Force), the American Institute of Certified Public Accountants and the SEC did not, or are not believed by management to, have a material impact on our present or future consolidated financial statements.

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 Report on Form 10-K for the fiscal year ended December 31, 2008.

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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 or under Risk Factors in our Annual Report on Form 10-K referred to above. In addition, there are factors not described in this Quarterly Report on Form 10-Q or in our Annual Report on Form 10-K 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, except as required by law, we assume no obligation to update any such forward-looking statements.

Overview

We are an innovative medical device company focused on the development of minimally invasive technologies for tissue and tumor ablation through cryoablation, which is the use of lethal ice to destroy tissue, such as tumors, for therapeutic purposes. We develop and manufacture devices for the treatment of prostate and renal cancers and we believe that our proprietary technologies have broad applications across a number of markets, including the ablation of tumors in the lung and liver and palliative intervention (treatment of pain associated with metastases).

Today, our FDA-cleared Cryocare Surgical System occupies a growing position in the urological market for treatment of prostate and renal cancers. Because of our initial concentration on prostate and renal cancers, the majority of our sales and marketing resources are directed toward the promotion of our technology to urologists. We also employ a dedicated sales team focused on the interventional radiology market in which our products are used to treat renal, liver and lung cancer and for palliative intervention. In addition to selling our cryoablation disposable products to hospitals and mobile service companies, we contract directly with hospitals for the use of our Cryocare Surgical System and disposable products on a fee-for-service basis. We intend to continue to identify and develop new markets for our cryoablation products and technologies, particularly in the area of tumor ablation.

Recent Events

The Galil Merger

On November 10, 2008, Endocare and Galil Medical, Ltd. (Galil), a privately held Israeli cryoablation company, entered into an Agreement and Plan of Merger (the Merger Agreement). Under the Merger Agreement, Orange Acquisitions Ltd., a newly formed wholly owned subsidiary of Endocare in Israel, will merge with and into Galil (the Merger), with Galil continuing after the Merger as the surviving company and a wholly owned subsidiary of Endocare. Upon the terms and subject to the conditions set forth in the Merger Agreement, at the effective time of the Merger, each issued and outstanding share of Galil will be converted into the right to receive shares of our common stock.

At the effective time of the Merger, it is expected that 11,199,195 shares of Endocare common stock will be issued in the Merger and Endocare will assume the outstanding stock options of Galil. The exact conversion ratio cannot be calculated until immediately prior to the effective time of the Merger, but it is expected that approximately 33 ordinary shares of Galil will be converted into one share of Endocare common stock. Immediately following the effective time of the Merger and attributing ownership to Galil s shareholders of shares to be deposited into the escrow account (the Escrow Shares), Galil s shareholders will own approximately 48.0%, and Endocare s stockholders will own approximately 52.0%, of Endocare s common stock, without giving effect to the shares issuable pursuant to the concurrent Financing described below. The Merger will have no effect on the number of shares of common stock of Endocare owned by existing Endocare stockholders. Subject to receipt of regulatory approvals, including the closing of the pending investigation by the Federal Trade Commission (the FTC), and approvals by Endocare stockholders and Galil shareholders, we are seeking to close the Merger in the second quarter of 2009.

The Merger Agreement terminates pursuant to its terms if the Merger has not occurred on or prior to June 30, 2009, unless the parties agree otherwise. The Merger Agreement contains certain other termination rights for both Endocare and Galil, including each party s right to terminate the Merger Agreement in the event the other party s available cash drops below $1.0 million for more than ten business days. Upon termination of the Merger Agreement for specified breaches and certain similar circumstances, either party may be required to pay the other party a termination fee of $900,000 and to reimburse such party for expenses incurred in connection with the Merger, up to a maximum of

$850,000. In addition, upon a termination of the Merger Agreement that does not trigger an obligation of a party to pay a termination fee in some circumstances, a party may nonetheless be required to reimburse the other party for expenses incurred in connection with the Merger, up to a maximum of $850,000.

Concurrent with the execution of the Merger Agreement, Endocare and certain existing institutional accredited stockholders of Endocare and Galil entered into a Stock Purchase Agreement, relating to the private placement by Endocare of 16,250,000 shares of Endocare common stock at a purchase price of $1.00 per share (the Financing). The offering gross proceeds to Endocare from the Financing are expected to be $16.3 million. The closing of the Financing is subject to the concurrent closing of the Merger and certain other conditions, including the sale of shares in the Financing with a minimum aggregate purchase price of $12 million and that Endocare s common stock remains listed on the NASDAQ Capital Market or the Over-The-Counter Bulletin Board. The issuance of common shares pursuant to the Merger Agreement and the Purchase Agreement is also subject to approval by our stockholders.

For additional information regarding the Merger and the Financing, see Note 1 *Organization and Operations* to the March 31, 2009 financial statements included above in this Quarterly Report on Form 10-Q.

The April 2009 HealthTronics Proposal

On April 9, 2009, we received a written proposal from HealthTronics, Inc. (HealthTronics), offering to purchase all of Endocare s outstanding common stock for $1.25 per share, with Endocare stockholders having the ability to elect to receive either cash or HealthTronics common stock as consideration (the HealthTronics Proposal). The proposal is subject to negotiation of a definitive written agreement and due diligence. Our Board of Directors has determined that the HealthTronics Proposal could reasonably be expected to lead to a Superior Proposal as defined in the Merger Agreement and is in the process of further evaluating the HealthTronics Proposal, including conducting due diligence and collecting other information appropriate for such evaluation. Our Board of Directors has not determined that the HealthTronics Proposal is in fact a Superior Proposal.

Strategy and Key Metrics

Our strategy is to strengthen cryoablation s position in the prostate and renal cancer markets, and further develop and increase the acceptance of our technology in the interventional radiology and oncology markets for treatment of liver and lung cancers and palliative intervention (treatment of pain associated with metastases). At the same time, we seek to achieve penetration across additional markets with our proprietary cryoablation technology.

The factors driving interest in and utilization of cryoablation include increased awareness and acceptance of cryoablation by industry thought leaders, continued publication of clinical data on the effectiveness of cryoablation, increased awareness among patients of cryoablation and its preferred outcomes as compared to other modalities, the efforts of our sales force and our continued expenditure of funds on patient education and advocacy.

Our primary objective is to grow market share. We have historically measured market share in terms of the estimated number of domestic cryoablation procedures performed with our Cryocare Surgical System and we calculate them using two primary components. The first component is the actual number of cryoablation cases for which we perform the service element on behalf of the healthcare facility and provide the required disposable products. In the second, we compute a procedure case equivalent based on direct sales of our cryoablation disposable products (without the service element) by using the expected disposable product usage for each procedure for those sales.

In 2005, we began gradually shifting our revenue model from providing the service component of our cryoablation procedure (revenues from cryoablation procedure fees) to focusing on selling our cryoablation disposable products without responsibility for the service element of the procedure (revenues from sales of cryoablation disposable products), thereby reducing the incremental revenues associated with our business in favor of a more straightforward disposable sales model.

Today, the transition is largely complete. Therefore, we believe that revenue growth is one of our most important business metrics. Because our customers are now directly purchasing and carrying inventories of our disposables

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and because of the resulting variability of probe use across patients and applications, making precise determinations about how many procedures are performed is increasingly difficult. As a consequence, we decided that, beginning with our operating results for the three months ended December 31, 2007, we would report the number of cryoprobes sold during the period.

The following table summarizes for the periods presented the total estimated domestic cryoablation procedures our customers performed or which are represented by the procedure case equivalent we computed from sales of our cryoablation disposable products. We also summarize the number of probes sold for each period. We are providing this summary to allow users of the financial information greater clarity regarding the transition from the former metric (procedure growth) we reported to the new metric (revenue growth measured by the number of probes sold) we are now reporting.

	Three Months Ended March 31,	
	2009	**2008**
Estimated domestic cryoablation procedures	2,352	2,568
Number of cryoprobes sold		
Straight probes	8,841	10,283
Right-angle probes	2,181	1,920
Total	11,022	12,203

The number of cryoprobes sold represents the domestic sales of cryoprobes during the periods presented. Straight probes are typically, although not always, used in prostate procedures and right-angle probes are typically used in procedures other than prostate procedures.

Results of Operations

Revenues and costs of revenues related to the following products and services for the three months ended March 31, 2009 and 2008 are as follows:

	Three Months Ended March 31,	
	2009	**2008**
Revenues:		
Cryoablation disposable products	$ 5,914	$ 5,916
Cryocare Surgical Systems	393	433
	6,307	6,349
Cryoablation procedure fees	1,745	1,690
Cardiac royalties	130	113
Other	(6)	(9)
	$ 8,176	$ 8,143
Costs of Revenues:		
Cryoablation disposable products and procedure fees	$ 2,294	$ 2,359
Cryocare Surgical Systems	41	146

$ 2,335	$ 2,505

Costs of revenues for cryoablation disposable products and procedure fees are combined for reporting purposes. Sales of cryoablation disposable products and procedure fees incorporate similar inventory when sold and we do not separately track the cost of disposable products sold directly to customers and those consumed in cryoablation procedures.

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We recognize revenues from sales of Cryocare Surgical Systems and disposable cryoprobes when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed and determinable and collectability is reasonably assured. Per-procedure fees are recorded when the service has been rendered.

Costs of revenues consist 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 under our placement program or with our sales and service personnel. 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 system owned by an unrelated third-party service provider. The fee paid to the third-party service provider is charged to costs of revenues when the procedure is performed and billed.

Research and development expenses include expenses associated with the design and development of new products as well as enhancements to existing products. We expense research and development costs when incurred. Our research and development efforts are occasionally subject to significant non-recurring expenses and fees that can cause some variability in our quarterly research and development expenses.

Selling and marketing expenses primarily consist of salaries, commissions and related benefits and overhead costs for employees and activities in the areas of selling, marketing and customer service. Expenses associated with advertising, trade shows, promotional and physician training costs related to marketing our products are also classified as selling and marketing expenses.

General and administrative expenses primarily consist of salaries and related benefits and overhead costs for employees and activities in the areas of legal affairs, finance, information technology, human resources and administration. Fees for attorneys, independent auditors and certain other outside consultants are also included where their services are related to general and administrative activities. This category also includes reserves for bad debt and litigation losses less amounts recoverable under our insurance policies. Litigation reserves and insurance recoveries are recorded when such amounts are probable and can be reasonably estimated. During the period ended March 31, 2009, general and administrative expenses also include certain costs related to the proposed Merger.

We account for equity awards to employees and non-employee directors under Statement of Financial Accounting Standards No. 123 (revised 2004), *Share Based Payment* (SFAS No. 123R). As of March 31, 2009, there was $0.6 million of total unrecognized compensation costs related to unvested stock options. That cost is expected to be amortized on a straight-line basis over a weighted average service period of 0.7 years less any stock options forfeited prior to vesting. Unrecognized compensation for restricted stock units was $1.7 million as of March 31, 2009 (assuming that all service and performance conditions will be met) and will be recognized over a weighted average period of 0.8 years. Compensation costs related to restricted stock units is recorded over the service period (2007 through 2009) if it is probable the performance conditions (profitability and sales goals) will be satisfied. Stock-based compensation expense recorded in the three months ended March 31, 2009 and 2008 was $0.4 million and $0.7 million, respectively.

Three Months Ended March 31, 2009 Compared to Three Months Ended March 31, 2008

Revenues

	Three Months Ended March 31,			
(dollars in thousands)	**2009**	**2008**	**$ Change**	**% Change**
Cryoablation disposable products	$ 5,914	$ 5,916	$ (2)	0.0%
Cryocare Surgical Systems	393	433	(40)	(9.2)%
	6,307	6,349	(42)	(0.7)%
Cryoablation procedure fees	1,745	1,690	55	3.3%
Cardiac royalties	130	113	17	15.0%
Other	(6)	(9)	3	33.3%

$ 8,176	$ 8,143	$ 33	0.4%

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The number of cryoprobes sold during the three months ended March 31, 2009 decreased by approximately 9.7 percent to 11,022 compared to 12,203 probes sold during this same period in 2008. The reduction in the number of cryoprobes sold was offset by higher average sales prices. Sales prices of both probes sold and used in procedures, increased 8.5 percent during the three months ended March 31, 2009 compared to this same period in 2008. This is largely caused by migration to higher priced probes, as well as annual price increases implemented in the second quarter of 2008. Sales of straight probes, which are typically, although not always, used in prostate cancer procedures decreased 14.0 percent and right-angle probes, which are typically used in procedures other than prostate cancer procedures, increased 13.6 percent.

Revenues from sales of Cryocare Surgical Systems decreased primarily due to the sales mix of new versus fully refurbished systems. Sales prices and the number of Cryocare Surgical Systems sold both domestically and internationally remained consistent year over year.

Cardiac royalty revenues increased due to increased sales by the licensee.

Cost of Revenues

	Three Months Ended March 31,		
(dollars in thousands)	**2009**	**2008**	**$ Change**
Cost of revenues	$2,335	$2,505	$(170)
Percent of revenues	28.6%	30.8%	

The decrease in cost of revenues is primarily due to a decrease in the volume of probes sold during the three months ended March 31, 2009 when compared to the same time period in 2008. The number of probes sold decreased 9.7 percent or 1,181 probes year over year. Additionally, due to sales mix of new versus fully refurbished Cryocare Surgical Systems, our cost of revenues decreased by $105,000 offset by an increase in procedures performed of $83,000.

Gross Profit and Gross Margin

	Three Months Ended March 31,		
(dollars in thousands)	**2009**	**2008**	**$ Change**
Cryoablation disposable products and procedure fees	$ 5,365	$ 5,247	$ 118
Cryocare surgical systems	352	287	65
Cardiac royalties and other	124	104	20
	$ 5,841	$ 5,638	$ 203

	Three Months Ended March 31,		Percentage Point
(percent of revenues)	**2009**	**2008**	**Change**
Cryoablation disposable products and procedure fees	65.6%	64.4%	1.2%
Cryocare Surgical Systems	4.3%	3.5%	0.8%
Cardiac royalties	1.5%	1.3%	0.2%
	71.4%	69.2%	2.2%

The increase in gross margin (gross profit as a percentage of revenues) of disposable products and procedure fees was primarily related to price increases offset by a decrease in the number probes sold year over year. Our manufacturing costs remained consistent year over year. Additionally, there was no significant adjustment to

inventory reserves for slow moving and obsolete inventory for the three months ended March 31, 2009 when

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compared to the $0.1 million adjustment that was recorded over the same time period in 2008. The increase in gross margin of Cryocare Surgical Systems was primarily related to product mix, as well as the mix of new versus fully refurbished systems sold. The increase in cardiac royalties was related to increased sales by the licensee.

Research and Development Expenses

	Three Months Ended March 31,			
(dollars in thousands)	**2009**	**2008**	**$ Change**	**% Change**
Research and development expenses	$578	$569	$ 9	1.6%
Percent of total revenues	7.1%	7.0%		

Expenses related to clinical studies for the three months ended March 31, 2009 have remained consistent with the same period last year. In both 2008 and 2009, we have focused a significant portion of our research dollars on those areas in which cryoablation research is required to substantiate reimbursement codes and coverage.

Selling and Marketing Expenses

	Three Months Ended March 31,			
(dollars in thousands)	**2009**	**2008**	**$ Change**	**% Change**
Selling and marketing expenses	$3,678	$3,828	$(150)	(3.9)%
Percent of total revenues	45.0%	47.0%		

The decrease is primarily due to cost reduction initiatives implemented in the first quarter of 2009 that resulted in a net savings of $0.3 million. Additionally, reductions in incentive and stock-based compensation expenses of $0.1 million further contributed to the overall decrease. Cost savings were offset by increases in sales commissions of $0.1 million and promotional expenses of $0.1 million.

General and Administrative Expenses

	Three Months Ended March 31,			
(dollars in thousands)	**2009**	**2008**	**$ Change**	**% Change**
General and administrative expenses	$3,461	$3,040	$421	13.8%
Percent of total revenues	42.3%	37.3%		

The increase was primarily due to higher legal and accounting fees of $0.9 million related to expenses incurred in relation to our pending merger with Galil Medical. The expenditures were recorded as general and administrative expenses in accordance with Statement of Financial Accounting Standards (SFAS) No. 141 (R), *Business Combinations.* The increase was offset by a reduction in stock-based compensation expense of $0.2 million related to the departure of our former interim CEO as well as a reduction in accrued performance-based restricted stock units expense when compared to a year ago. Additionally, the increase was offset by a reduction of $0.2 million due to timing of progress on the resolution of past due state and local tax obligations, which are primarily sales and use tax obligations. The reduction includes an amnesty of $87,000 granted to us by a state and local tax authority in March 2009. The remaining variance is the net savings achieved due to cost reduction initiatives implemented during the first quarter of 2009.

Interest Income (expense), Net

	Three Months Ended March 31,		
(dollars in thousands)	**2009**	**2008**	**$ Change**

				% Change
Interest income (expense), net	$ (91)	$109	$(200)	(183.5)%
Percent of total revenues	(1.1)%	1.3%		

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Interest income, net in the 2009 and 2008 periods includes interest income earned from the investment of our cash balances, as well as interest expense related to our line of credit. Interest income decreased in the first quarter of 2009 due to lower cash balances and lower average yield rates from our investments. Additionally, the collection in full of our note receivable from SRS Medical resulted in no interest income recorded on the note during the three months ended March 31, 2009. The note was fully satisfied in August 2008 and no future interest payments will be received. We continue to accrue interest expense on past due state and local tax obligations until resolutions are reached with the applicable tax authorities.

Net Loss

	Three Months Ended March 31,			
(dollars in thousands)	**2009**	**2008**	**$ Change**	**% Change**
Net loss	$(1,967)	$(1,690)	$277	16.4%
Percent of total revenues	(24.1)%	(20.8)%		

Net loss for the three months ended March 31, 2009 was $0.16 per basic and diluted share on 12.2 million weighted average shares outstanding, compared to a net loss of $0.14 per basic and diluted share on 11.8 million weighted average shares outstanding during the same period in 2008.

Liquidity and Capital Resources

Since inception, we have incurred losses from operations and have reported negative cash flows. As of March 31, 2009 we had $2.6 million in cash and cash equivalents and $2.8 million of the cash balance is borrowed under our line of credit and is payable May 27, 2009. We are in discussions with the lender to obtain more permanent long-term financing, although such financing may not be available or available on terms acceptable to us. Net cash used in operations was $1.0 million during the three months ended March 31, 2009 and $2.6 million during the three months ended March 31, 2008. We do not expect to reach positive adjusted Earnings Before Income Tax, Depreciation and Amortization (EBITDA) on an annual basis in 2009, both as a stand-alone company and as a combined company after the proposed Merger discussed in Note 1 *Organization and Operations* to the March 31, 2009, financial statements. We expect to continue to generate losses from operations for the foreseeable future. These losses have resulted in part from our continued investment to gain acceptance of our technology and investment in initiatives that we believe should ultimately result in cost reductions. In addition to working capital needs for our operations and growth initiatives, we have also incurred significant expenditures under indemnification obligations for our former officers and directors through the third quarter of 2008 and have large outstanding state and local tax liabilities as described below. In addition, we have incurred legal, accounting and other fees related to the proposed Merger and Financing.

We expect to use existing cash reserves, working capital through the sale of our products and the proceeds from borrowings on our line of credit to fund our operations until we complete the Merger and Financing. We believe the net proceeds from the Financing combined with expected expense reductions from eliminating duplicate or redundant facilities, infrastructure and functions will be adequate to enable the post-merger combined company to reach positive adjusted EBITDA.

Through December 31, 2008 we incurred significant payments under our indemnification agreements with certain former officers and directors. These costs, net of insurance recoveries totaled $1.8 million for the year ended December 31, 2008. Our obligations to indemnify our former CFO and former CEO were terminated in August and October 2008, respectively.

We continue to face large cash expenditures in the future related to past due state and local taxes, primarily sales and use tax obligations, which we estimate to be approximately $2.1 million and was fully accrued as of March 31, 2009. We are in the process of negotiating resolutions of the past due state and local tax obligations with the

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applicable tax authorities. However, there is no assurance that these obligations will be reduced as a result of the negotiations or that we will be allowed to pay the amounts due over an extended period of time.

During the quarter ended March 31, 2009 and the year ended December 31, 2008, we incurred $1.3 million and $2.4 million respectively, in relation to potential strategic transactions including the proposed Merger. We estimate that $1.1 million in additional legal and accounting expenses will be incurred in 2009 to complete the Merger and Financing and we will pay total transaction fees currently estimated at approximately $1.0 million from the Financing proceeds to our investment banker at closing. Expenditures related to the Merger are recorded as general and administrative expenses as incurred in accordance with Statement of Financial Accounting Standards (SFAS) No. 141(R), *Business Combinations*. Fees related to the Financing and share issuance will be recorded as a reduction of paid in capital. Consummation of the Merger is expected to continue to require a significant use of cash including post-closing integration costs, or, if the Merger is not consummated, any continued exploration of other strategic alternatives.

Our cash needs are not entirely predictable. We have historically financed our operations and growth through borrowings and equity financings. If the Merger and Financing are consummated, the net proceeds of the Financing will be used to finance the operations, costs of integration and cash flow needs of the combined company. The expected gross proceeds to Endocare of the proposed Financing are expected to be approximately $16.3 million. The closing of the Financing is subject to the concurrent closing of the proposed Merger and certain other conditions including the sale of shares with a minimum aggregate purchase price of $12.0 million. In the event that our available cash drops below $1.0 million for more than ten business days, Galil has the right to terminate the Merger Agreement.

If additional cash is required before we complete the Merger and Financing, we may access the remaining funds available under our $4.0 million bank credit facility. The funds we can borrow are based on eligible receivables and inventory as defined. The credit facility includes a subjective acceleration clause and a requirement to maintain a lock box with the lender, the proceeds from which will be applied to reduce the outstanding borrowings upon our default or if other conditions are met. During the first quarter of 2009, we borrowed an additional $1.0 million under our credit facility, bringing the total amount currently outstanding under the credit facility to $2.8 million. As of March 31, 2009, there was $1.2 million available for additional borrowing under the credit facility. Our credit facility contains a minimum tangible net worth covenant measured on a monthly basis. The future availability of funds from our bank credit facility is subject to many conditions, including the subjective acceleration clause and other provisions that are predicated on events not within our control. We cannot access the bank credit facility if we fail to comply with all covenants and borrowing conditions. If a waiver is not granted, the bank can accelerate the outstanding indebtedness under the credit facility and terminate the credit facility. Under the subjective acceleration clause, the bank can accelerate payment on all outstanding borrowings and cease to make further advances to us in the event of default or if the bank determines in its judgment that a material adverse change has occurred or will occur.

We were not in compliance with the minimum tangible net worth covenant as of December 31, 2008 and January 31, 2009, and received a waiver from the bank with respect to this noncompliance on February 26, 2009. The waiver also redefines the minimum tangible net worth requirement and provides new lower net worth requirements for February through April 2009. In addition, on February 26, 2009, the credit facility, which was due to expire on that date, was extended to May 27, 2009. We are in discussions with the lender to obtain more permanent long-term financing, although such financing may not be available or available on terms acceptable to us. Also, there is no assurance that we will be able to comply with all borrowing requirements and covenants in future periods, that we can obtain a waiver if additional events of default occur or that the lender will not exercise the subjective acceleration clause.

There is no assurance that the Merger and Financing will occur and we cannot guarantee the availability of our existing capital resources or that they will be sufficient to fund our ongoing operations to the point where our operations will generate positive cash flows on a consistent basis. We will continue to assess the adequacy of our capital resources and may need to use existing and new sources of capital to finance operations and the growth of the business. If the Merger and Financing are not consummated, Endocare, as a stand-alone company, expects that it will need to raise additional capital during 2009 to fund its ongoing operations. Should such financing be unavailable or prohibitively expensive when we require it, the consequences would have a material adverse effect on our business,

financial condition, results of operations and cash flows.

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Our continuing losses, cashflow deficits and obligations, the scheduled expiration of our credit facility in May 2009, along with the contingencies in our funding sources, together raise substantial doubt about our ability to continue as a going concern. The accompanying financial statements have been prepared assuming that we will continue as a going concern and do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result from the outcome of this uncertainty.

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 the risk of loss. Our financial instruments include cash, cash equivalents, accounts and notes receivable, minority investments, accounts payable, accrued liabilities and a line of credit. 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.

As of March 31, 2009, $1.1 million of our cash is invested in a money market mutual fund (the Citi Institutional Liquid Reserves) that includes in its investment portfolio commercial paper, time deposits, certificates of deposits, bank notes, corporate bonds and notes and U.S. government agency securities. Although the fund seeks to preserve the value of the investment at $1.00 per share, it is possible to lose our principal if the underlying securities suffer losses. As of January 31, 2009, the fund reported that certain securities within the portfolio are illiquid, in default, under restructuring or have been subject to a ratings downgrade. However, the fund continues to report a per share net asset value (NAV) of $1.00, representing the price at which investors buy (bid price) and sell (redemption price) fund shares from and to the fund company. The NAV is computed once at the end of each trading day based on the closing market prices of the portfolio s securities. We believe that our investment has not been impaired and that we can withdraw our funds at any time without restriction. Effective September 2008, the federal government provided a temporary guarantee through April 30, 2009 on publicly traded or regulated money market mutual funds that elect to participate in the program. The guarantee may be extended through September 18, 2009 at the discretion of the U.S. Treasury Department. We will continue to monitor the value of the fund periodically for potential indicators of impairment.

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.* We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports pursuant to the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms and that such information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As required by Rule 13a-15(b) of the Securities Exchange Act of 1934, as amended, we carried out an evaluation, under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the quarter covered by this report. Based on the foregoing, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level.

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(b) *Changes in Internal Controls.* There was no change in our internal control over financial reporting during our first fiscal quarter for 2009 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***

Please refer to the legal proceedings described in Part I, Item 3, in the Form 10-K that we filed on March 30, 2009.

Item 1A. ***Risk Factors***

Please see our 2008 Annual Report on Form 10-K filed with the SEC on March 30, 2009 that includes a detailed discussion of our risk factors. There have been no material changes in our risk factors from those disclosed in the Form 10-K, except as set forth below.

We have a limited operating history with significant losses and can give no assurances when or whether we will ever be profitable or have capital sufficient to sustain our operations.

We have yet to establish any history of profitable operations. We have incurred losses from operations of $1.9 million during the quarter ended March 31, 2009, and $8.6 million and $9.3 million for the fiscal years ended December 31, 2008 and 2007, respectively. As a result, at March 31, 2009 and December 31, 2008 we had an accumulated deficit of $200.1 million and $198.2 million, respectively. We have incurred net losses from continuing operations of $2.0 million in the quarter ended March 31, 2009, and $8.4 million and $8.9 million, during the fiscal years ended December 31, 2008 and 2007, respectively. We had an operating cash flow deficit of $1.0 million for the quarter ended March 31, 2009, and $8.1 million and $4.6 million, for the years ended December 31, 2008 and 2007, respectively. As of March 31, 2009, we had cash and cash equivalents of $2.6 million.

To date, our revenues have not been sufficient to sustain our operations. We expect that our revenues as a standalone company will not be sufficient to sustain our operations for the foreseeable future. We can give no assurances when or whether we will ever be profitable.

As a result of our recurring losses from operations and limited capital resources, our independent registered public accounting firm s report on our financial statements as of and for the fiscal year ended December 31, 2008 includes an explanatory paragraph expressing substantial doubt about our ability to continue as a going concern.

We have historically financed our operations and growth through borrowings and equity financings. In the short term, we expect to use existing cash reserves and working capital through the sale of our products, and if the Merger and Financing are consummated, the proceeds of the Financing, to finance our projected operating and cash flow needs. However, our cash needs are not entirely predictable, and additional cash may be required, including from our bank credit facility. Furthermore, inclusion of a going concern qualification in the report of our independent registered public accountants may have a negative impact on our ability to raise additional capital and may adversely impact our stock price. The credit facility is currently scheduled to expire on May 27, 2009. Upon termination of the credit facility, we may not be able to renew our credit facility or replace the funds that are available under the credit facility.

Our credit facility contains a minimum tangible net worth covenant measured on a monthly basis. We were not in compliance with this covenant as of December 31, 2008 and January 31, 2009. In connection with the extension we executed on February 26, 2009, the bank granted us a waiver of the noncompliance, redefined the tangible net worth requirement and established a new lower tangible net worth covenant for the months from February through April 2009. We are in discussions with the lender to obtain more permanent long-term financing although such financing may not be available or available on terms acceptable to us.

We may not have sufficient capital to fund our ongoing operations. In addition, in the event that our available cash drops below $1.0 million for more than ten business days, Galil has the right to terminate the Merger Agreement.

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If Endocare fails to meet all applicable continued listing requirements of the NASDAQ Capital Market and NASDAQ determines to delist Endocare s common stock, the market liquidity and market price of Endocare s common stock could decline.

Our common stock is currently listed on the NASDAQ Capital Market. In order to maintain that listing, Endocare must satisfy minimum financial and other listing requirements. In addition, the issuance of Endocare common stock in the Merger and the Financing may constitute a change of control for purposes of NASDAQ Marketplace Rule 5635(b). Whether a change of control exists under NASDAQ Marketplace Rule 5635(b) is a facts and circumstances determination that is currently being undertaken by NASDAQ based on an evaluation of certain factors, such as changes in Endocare s management, Board of Directors, voting power, ownership and financial structure as a result of the Merger and the Financing. If NASDAQ determines that the Merger and the Financing constitute a change of control of Endocare, Endocare will be required to submit a new original listing application with NASDAQ and comply with the NASDAQ Capital Market initial listing requirements, including a $4.00 minimum bid price, in order for Endocare s common stock to continue to be listed on the NASDAQ Capital Market after consummation of the Merger and the Financing.

In addition, NASDAQ Marketplace Rule 5550(b)(1) requires minimum stockholders equity of $2.5 million for continued listing on the NASDAQ Capital Market. As of March 31, 2009, our total stockholders equity was $1.9 million. Within 15 days following notification from NASDAQ, we will be required to submit a plan of compliance to demonstrate how we intend to remedy this deficiency within the following 30-60 days and to sustain compliance for the next six to 12 months.

Further, NASDAQ Marketplace Rule 5550(a)(2) sets a minimum per share price of $1.00 for continued listing on the NASDAQ Capital Market. Endocare s common stock has traded below $4.00 since July 21, 2008, and below $1.00 since May 7, 2009. The closing price of Endocare s common stock as of May 14, 2009 was $0.90.

There can be no assurance that Endocare will be able to retain its listing on the NASDAQ Capital Market if NASDAQ determines that the Merger and the Financing constitute a change of control or determines to delist Endocare for failure to meet the $2.5 million minimum stockholders equity or the $1.00 minimum bid price for continued listing.

If Endocare fails to meet all applicable listing requirements of the NASDAQ Capital Market at any time and NASDAQ determines to delist its common stock, an active trading market for Endocare s common stock may not be sustained and the market price of Endocare s common stock could decline. If an active trading market for Endocare s common stock is not sustained, it will be difficult for Endocare s stockholders to sell shares of Endocare s common stock without further depressing the market price of such common stock, if at all. A delisting of Endocare s common stock also could make it more difficult for Endocare to obtain financing for the continuation of operations and could result in the loss of confidence by investors, suppliers and employees.

Item 2. ***Unregistered Sales of Equity Securities and Use of Proceeds***

Not applicable.

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

Not applicable.

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

Not applicable.

Item 5. ***Other Information***

None.

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Item 6. ***Exhibits***

A list of exhibits to this Form 10-Q is found in the Exhibit Index immediately following the Signature Page of this Form 10-Q, which is hereby incorporated by reference herein.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this Form 10-Q to be signed on its behalf by the undersigned, thereunto duly authorized.

ENDOCARE, INC.

By: /s/ MICHAEL R. RODRIGUEZ
Michael R. Rodriguez
Senior Vice President, Finance and Chief Financial Officer
(Principal Financial and Accounting Officer)

Date: May 15, 2009

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EXHIBIT INDEX

Exhibit No.	Description
2.1(1)	Stock Purchase Agreement, dated January 13, 2006, by and among the Company, Plethora Solutions Holdings plc and Timm Medical Technologies, Inc. The schedules and other attachments to this exhibit were omitted. The Company agrees to furnish a copy of any omitted schedules or attachments to the Securities and Exchange Commission upon request.
2.2(2)	$1,425,000 Secured Convertible Promissory Note, dated February 10, 2006, from Plethora Solutions Holdings plc to the Company.
2.3(13)	Agreement and Plan of Merger, dated as of November 10, 2008, by and among the Company, Orange Acquisitions Ltd. and Galil Medical Ltd.
3.1(3)	Restated Certificate of Incorporation.
3.2(3)	Certificate of Designation of Series A Junior Participating Preferred Stock of the Company.
3.3(3)	Certificate of Amendment of Restated Certificate of Incorporation, as filed with the Delaware Secretary of State on September 25, 2000.
3.4(4)	Certificate of Amendment of Restated Certificate of Incorporation, as filed with the Delaware Secretary of State on August 17, 2007.
3.5(5)	Amended and Restated Bylaws of the Company.
3.6(6)	Amendment No. 1 to Amended and Restated Bylaws of the Company.
4.1(7)	Form of Stock Certificate.
4.2(8)	Form of Series A Warrant.
4.3(8)	Form of Series B Warrant.
4.4(9)	Rights Agreement, dated March 31, 1999, between the Company and U.S. Stock Transfer Corporation, which includes the form of Certificate of Designation for the Series A Junior Participating Preferred Stock as Exhibit A, the form of Rights Certificate as Exhibit B and the Summary of Rights to Purchase Series A Preferred Shares as Exhibit C.
4.5(10)	Amendment No. 1 to Rights Agreement, dated June 24, 2005, between the Company and U.S. Stock Transfer Corporation.
4.6(11)	Amendment No. 2 to Rights Agreement, dated as of March 26, 2009, between Endocare and Computershare Trust Company, N.A. (as successor-in-interest to U.S. Stock Transfer Corporation) (including form of rights certificate).
10.1(12)	

	Limited Waiver and Amendment to Loan Documents, dated as of February 26, 2009, by and between Endocare, Inc. and Silicon Valley Bank.
31.1	Certification under Section 302 of the Sarbanes-Oxley Act of 2002 for Clint B. Davis.
31.2	Certification under Section 302 of the Sarbanes-Oxley Act of 2002 for Michael R. Rodriguez.

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Exhibit No.	Description
32.1	Certification under Section 906 of the Sarbanes-Oxley Act of 2002 for Clint B. Davis.
32.2	Certification under Section 906 of the Sarbanes-Oxley Act of 2002 for Michael R. Rodriguez.

Management contract or compensatory plan or arrangement.

(1) Previously filed as an exhibit to our Form 8-K filed on January 18, 2006.

(2) Previously filed as an exhibit to our Form 10-K filed on March 16, 2006.

(3) Previously filed as an exhibit to our Registration Statement on Form S-3 filed on September 20, 2001.

(4) Previously filed as an exhibit to our Form 8-K filed on August 21, 2007.

(5) Previously filed as an exhibit to our Form 10-K filed on March 15, 2004.

(6) Previously filed as an exhibit to our Form 8-K filed on March 5, 2008.

(7) Previously filed as an exhibit to our Form 10-K for the year ended December 31, 1995.

(8) Previously filed as an exhibit to our Form 8-K filed on March 16, 2005.

(9) Previously filed as an exhibit to our Form 8-K filed on June 3, 1999.

(10) Previously filed as an exhibit to our Form 8-K filed on June 28, 2005.

(11) Previously filed as an exhibit to our Form S-4/A filed on April 8, 2009.

(12) Previously filed as an exhibit to our Form 8-K filed on February 27, 2009.

(13) Previously filed as an exhibit to our Form 8-K filed on November 12, 2008.

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