

PRO PHARMACEUTICALS INC

Form 10-Q

November 13, 2006

Table of Contents

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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**Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the quarterly period ended September 30, 2006

**Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File No. 000-32877

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**PRO-PHARMACEUTICALS, INC.**

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**Nevada**  
(State or other jurisdiction)

of incorporation)

7 Wells Avenue, Newton, Massachusetts  
(Address of Principal Executive Offices)

(617) 559-0033

(Registrant's Telephone Number, Including Area Code)

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**04-3562325**  
(I.R.S. Employer

Identification No.)

**02459**  
(Zip Code)

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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. YES  NO

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

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer

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

The number of shares outstanding of the registrant's common stock as of November 13, 2006 was 29,751,208.

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**Table of Contents**

**PRO-PHARMACEUTICALS, INC.**

**INDEX TO FORM 10-Q**

**FOR THE QUARTER ENDED SEPTEMBER 30, 2006**

	<b>PAGE</b>
<b><u>PART I FINANCIAL INFORMATION</u></b>	
ITEM 1.	
<u>Unaudited Condensed Consolidated Financial Statements</u>	
<u>Condensed Consolidated Balance Sheets as of September 30, 2006 and December 31, 2005</u>	3
<u>Condensed Consolidated Statements of Operations for the Three and Nine Months Ended September 30, 2006 and September 30, 2005, and for the Cumulative Period From Inception (July 10, 2000) to September 30, 2006</u>	4
<u>Condensed Consolidated Statement of Stockholders' Equity for the Nine Months Ended September 30, 2006</u>	5
<u>Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2006 and September 30, 2005, and for the Cumulative Period From Inception (July 10, 2000) to September 30, 2006</u>	6
<u>Notes to Unaudited Condensed Consolidated Financial Statements</u>	7
ITEM 2.	
<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	13
ITEM 3.	
<u>Quantitative and Qualitative Disclosures about Market Risk</u>	19
ITEM 4.	
<u>Controls and Procedures</u>	19
<b><u>PART II OTHER INFORMATION</u></b>	
ITEM 1.	
<u>Legal Proceedings</u>	20
ITEM 1A.	
<u>Risk Factors</u>	20
ITEM 6.	
<u>Exhibits</u>	21
<u>SIGNATURES</u>	21

**Table of Contents****Part I - Financial Information****Item 1. Unaudited Condensed Financial Statements****PRO-PHARMACEUTICALS, INC.****(A Development-Stage Company)****CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED) (dollars in thousands except share and per share amounts)**

	September 30, 2006	December 31, 2005
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 3,125	\$ 4,466
Certificate of deposit	5,000	
Prepaid expenses and other current assets	151	228
Total current assets	8,276	4,694
PROPERTY AND EQUIPMENT NET	121	60
INTANGIBLE ASSETS NET	264	209
<b>TOTAL ASSETS</b>	<b>\$ 8,661</b>	<b>\$ 4,963</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Accounts payable	\$ 416	\$ 295
Accrued expenses	681	1,085
Current portion of convertible debt instrument and warrant liabilities	5,250	
Total current liabilities	6,347	1,380
LONG TERM PORTION CONVERTIBLE DEBT INSTRUMENT AND WARRANT LIABILITIES	2,277	
OTHER LONG TERM LIABILITIES	22	
Total liabilities	8,646	1,380
<b>CONTINGENCIES (Note 6)</b>		
<b>STOCKHOLDERS EQUITY:</b>		
Common stock, \$0.001 par value; 100,000,000 shares authorized, 29,379,155 and 27,315,411 issued and outstanding at September 30, 2006 and December 31, 2005, respectively; Undesignated shares, \$0.01 par value; 10,000,000 shares authorized, none issued and outstanding	29	27
Additional paid-in capital	34,189	29,986
Deficit accumulated during the development stage	(34,203)	(26,430)
Total stockholders equity	15	3,583
<b>TOTAL LIABILITIES AND STOCKHOLDERS EQUITY</b>	<b>\$ 8,661</b>	<b>\$ 4,963</b>

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See notes to unaudited condensed consolidated financial statements.

**Table of Contents****PRO-PHARMACEUTICALS, INC.****(A Development-Stage Company)****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED) (dollars in thousands except share and per share amounts)**

	Three Months Ended September 30,		Nine Months Ended September 30,		Cumulative Period
	2006	2005	2006	2005	from Inception
					(July 10, 2000)
					to
	2006	2005	2006	2005	September 30, 2006
<b>OPERATING EXPENSES:</b>					
Research and development	\$ 863	\$ 859	\$ 2,315	\$ 2,292	\$ 12,824
General and administrative	1,066	846	3,437	2,594	17,461
Total operating expenses	\$ (1,929)	\$ (1,705)	\$ (5,752)	\$ (4,886)	\$ (30,285)
<b>OTHER INCOME AND EXPENSE</b>					
Interest income	36	25	106	91	460
Interest expense	(520)		(1,428)		(3,679)
Change in fair value of convertible debt instrument and warrant liabilities	3,133		(699)		(699)
Total other income and (expense)	\$ 2,649	\$ 25	\$ (2,021)	\$ 91	\$ (3,918)
NET INCOME (LOSS)	\$ 720	\$ (1,680)	\$ (7,773)	\$ (4,795)	\$ (34,203)
NET INCOME (LOSS) PER SHARE BASIC	\$ 0.03	\$ (0.06)	\$ (0.28)	\$ (0.18)	
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING BASIC	28,600,489	27,315,411	27,884,020	27,315,411	
NET INCOME (LOSS) PER SHARE DILUTED	\$ 0.02	\$ (0.06)	\$ (0.28)	\$ (0.18)	
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING DILUTED	30,426,401	27,315,411	27,884,020	27,315,411	

See notes to unaudited condensed consolidated financial statements.

**Table of Contents****PRO-PHARMACEUTICALS, INC.**

(A Development-Stage Company)

**CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY**

NINE MONTHS ENDED SEPTEMBER 30, 2006 (UNAUDITED) (dollars in thousands except share and per share amounts)

	Common Stock		Deficit		Total
	Number of Shares	Amount	Additional Paid-in Capital	Accumulated	
					During the
				Development	
BALANCE, JANUARY 1, 2006	27,315,411	\$ 27	\$ 29,986	\$ (26,430)	\$ 3,583
Net loss				(7,773)	(7,773)
Common stock issued related to convertible debenture conversions	476,202	1	1,744		1,745
Common stock issued related to convertible debenture redemptions	1,587,542	1	2,154		2,155
Stock-based compensation expense			305		305
BALANCE, SEPTEMBER 30, 2006	29,379,155,	\$ 29	\$ 34,189	\$ (34,203)	\$ 15

See notes to unaudited condensed consolidated financial statements.

**Table of Contents****PRO-PHARMACEUTICALS, INC.****(A Development-Stage Company)****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED) (dollars in thousands)**

	Nine Months Ended		Cumulative
	September 30,		Period from
			Inception
			(July 10, 2000)
			to September 30,
	2006	2005	2006
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net loss	\$ (7,773)	\$ (4,795)	\$ (34,203)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	49	52	356
Stock-based compensation expense	305	16	1,362
Non-cash interest expense	1,428		3,602
Change in fair value of convertible debt instrument and warrant liabilities	699		699
Write off of intangible assets			136
Changes in current assets and liabilities:			
Prepaid expenses and other current assets	77	(73)	(148)
Accounts payable and accrued expenses	(283)	219	1,215
Changes in long term liabilities:	22		22
Net cash used in operating activities	(5,476)	(4,581)	(26,959)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Purchases of property and equipment	(96)	(20)	(412)
Purchase of certificate of deposit	(5,000)		(5,000)
Increase in patents costs and other assets	(69)	(101)	(357)
Net cash used in investing activities	(5,165)	(121)	(5,769)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Net proceeds from issuance of common stock and warrants			25,309
Net proceeds from issuance of convertible debt instruments	9,300		10,621
Repayment of convertible debt instruments			(86)
Proceeds from shareholder advances			9
Net cash provided by financing activities	9,300		35,853
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	<b>(1,341)</b>	<b>(4,702)</b>	<b>3,125</b>
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>	<b>4,466</b>	<b>10,704</b>	
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>	<b>\$ 3,125</b>	<b>\$ 6,002</b>	<b>\$ 3,125</b>
<b>SUPPLEMENTAL DISCLOSURE</b> Cash paid for interest	<b>\$</b>	<b>\$</b>	<b>\$ 19</b>



See notes to unaudited condensed consolidated financial statements.

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**Table of Contents**

**PRO-PHARMACEUTICALS, INC.**

**(A DEVELOPMENT-STAGE COMPANY)**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (dollar amounts in thousands except share and per share amounts))**

**1. BASIS OF PRESENTATION**

The unaudited condensed consolidated financial statements as reported in this Quarterly Report on Form 10-Q reflect all adjustments which are, in the opinion of management, necessary to present fairly the financial position of Pro-Pharmaceuticals, Inc. (the Company) as of September 30, 2006 and the results of its operations for the three and nine months ended September 30, 2006 and September 30, 2005 and cumulative from inception (July 10, 2000) through September 30, 2006, statement of stock holders' equity for the nine months ended September 30, 2006 and its cash flows for the nine months ended September 30, 2006 and 2005 and cumulative from inception through September 30, 2006. All adjustments made to the interim financial statements include all those of a normal and recurring nature. The results for interim periods are not necessarily indicative of results which may be expected for any other interim period or for the full year.

The unaudited condensed consolidated financial statements of the Company should be read in conjunction with its Annual Report on Form 10-K for the year ended December 31, 2005.

As shown in the unaudited condensed consolidated financial statements, the Company incurred net losses of \$34,203 for the cumulative period from inception through September 30, 2006. The Company's net losses have resulted principally from costs associated with (i) research and development expenses, including clinical trial costs, (ii) general and administrative activities and (iii) the Company's debt financing transactions including interest and the costs related to fair value accounting for the Company's convertible debt instrument and warrant liabilities. As a result of planned expenditures for future research, discovery, development and commercialization activities and potential legal cost to protect its intellectual property, the Company expects to incur additional losses and use additional cash in its operations for the foreseeable future. From inception through September 30, 2006, the Company has raised \$35,930 in capital through sale and issuance of common stock, common stock purchase warrants, and debt securities in public and private offerings. From inception through September 30, 2006, the Company has used \$26,959 of cash in its operations. At September 30, 2006, the Company had \$3,125 of cash and cash equivalents and a \$5,000 certificate of deposit to fund future operations. Management believes there is sufficient cash to fund operations through at least June 2007.

The Company is subject to a number of risks similar to those of other development-stage companies, including dependence on key individuals, uncertainty of product development and generation of revenues, dependence on outside sources of capital, risks associated with clinical trials of products, dependence on third-party collaborators for research operations, need for regulatory approval of products, successful protection of intellectual property, and competition with larger, better-capitalized companies. Successful completion of the Company's development program and, ultimately, the attainment of profitable operations is dependent upon future events, including obtaining adequate financing to fulfill its development activities and achieving a level of revenues adequate to support the Company's cost structure. There are no assurances, however, that the Company will be able to obtain additional financing on favorable terms, or at all, or successfully market its products.

*Impact of New Accounting Standards* In June 2006, the Financial Accounting Standards Board issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (the Interpretation). This Interpretation clarifies the accounting for uncertainty in income taxes recognized in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. This Interpretation prescribes a more-likely-than-not recognition threshold that a tax position will be sustained upon examination and a measurement attribute for the financial statement recognition of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. This Interpretation is effective for fiscal years beginning after December 15, 2006. The cumulative effect of applying the provisions of this Interpretation shall be reported as an adjustment to the opening balance of retained earnings in 2007. The Company is currently evaluating the impact of the Interpretation on its consolidated financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108). SAB 108 provides guidance on how prior year misstatements should be taken into consideration when quantifying misstatements in current year financial statements for purposes of determining whether the current year's financial statements are materially misstated. The Company will be required to adopt SAB 108 in the fourth quarter of fiscal year 2006. Management does not anticipate the adoption of SAB 108 will have a material impact on the Company's consolidated financial statements.

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In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* ( SFAS No. 157 ). SFAS 157 clarifies the principle that fair value should be based on the assumptions market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. Under the standard, fair value measurements would be separately disclosed by level within the fair value hierarchy. The Company will be required to adopt SFAS No. 157 in the first quarter of fiscal year 2008. Management is currently evaluating the requirements of SFAS No. 157 and has not yet determined the impact, if any, on the Company's consolidated financial statements.

### **2. STOCK-BASED COMPENSATION**

*Summary of Stock-Based Compensation Plans* In October 2001, the Company's Board of Directors adopted the Pro-Pharmaceuticals, Inc. 2001 Stock Incentive Plan (the Incentive Plan ), which permits awards of incentive and nonqualified stock options and other forms of incentive compensation to employees and non-employees such as directors and consultants. Options granted under the Incentive Plan vest either immediately or over a period of up to three years, and expire three years to ten years from the grant date. Amended by the stockholders in 2004, there are 5,000,000 shares of common stock in the Incentive Plan and as of September 30, 2006, there were 2,484,000 shares available for future grants under the Incentive Plan.

**Table of Contents**

In 2004, the stockholders approved the Pro-Pharmaceuticals, Inc. 2003 Non-Employee Director Stock Option Plan (the Director Plan), which permits awards of stock options to non-employee directors. There are 1,000,000 shares of common stock in the Director Plan. At September 30, 2006, there were 871,250 shares available for future grant.

In addition, the Company has awarded 464,604 non-plan stock option grants to non-employees. The non-plan grants have vesting periods and expiration dates similar to those options granted under the Incentive Plan. All 464,604 non-plan grants are outstanding at September 30, 2006.

*Change in Accounting for Stock-Based Compensation* Through December 31, 2005, the Company accounted for stock-based compensation to employees and non-employee directors under the intrinsic value method in accordance with Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, (APB No. 25) and the related interpretations. Under APB No. 25, no compensation expense is recognized for stock options granted at fair market value and with fixed terms.

On January 1, 2006, the Company adopted SFAS 123R, Accounting for Stock-Based Compensation, (SFAS 123R) using the modified prospective method, which results in the provisions of SFAS 123R being applied to the consolidated financial statements on a going-forward basis. Prior periods have not been restated. SFAS 123R requires companies to recognize stock-based compensation awards granted to its employees as compensation expense on a fair value method. Under the fair value recognition provisions of SFAS 123R, stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense over the service period, which generally represents the vesting period. The grant date fair value of stock options is calculated using the Black-Scholes option-pricing model. The expense recognized over the service period is required to include an estimate of the awards that will be forfeited. Previously, the Company recorded the impact of forfeitures as they occurred.

Stock-based compensation expense for both employees and non-employees totaled \$81 for the three months ended September 30, 2006. There was no stock-based compensation expense for the three months ended September 30, 2005. For the nine months ended September 30, 2006 and 2005 and for the cumulative period from inception to September 30, 2006, stock based compensation expense was \$305, \$16 and \$1,362 respectively.

The Company had previously adopted the disclosure-only provisions of SFAS No. 123, Accounting for Stock-Based Compensation, as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure. The following table illustrates the effect on net loss and basic and diluted loss per share for the three and nine months ended September 30, 2005 and for the cumulative period from inception to September 30, 2006 as if the Company had applied the fair value recognition provisions of FAS 123 to stock-based employee awards.

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005	Cumulative Period from Inception (July 10, 2000) to September 30, 2006
Net loss as reported	\$ (1,680)	\$ (4,795)	\$ (34,203)
Deduct employee stock-based compensation determined under the fair-value method	(38)	(188)	(4,214)
Net loss pro forma	\$ (1,718)	\$ (4,983)	\$ (38,417)
Basic and diluted loss per share:			
As reported	\$ (.06)	\$ (0.18)	
Pro forma	\$ (.06)	\$ (0.18)	

The fair value of the stock options, is determined using the Black-Scholes option-pricing model. Key assumptions used to apply this option-pricing model are as follows:

	Nine Months Ended September 30,		Cumulative Period from Inception (July 10, 2000) to September 30, 2006
	2006	2005	
Risk-free interest rate	4.81%	3.53%	2.96%
Expected life of the options	5 years	3 years	3.3 years
Expected volatility of the underlying stock	65%	75%	89%
Expected dividend rate	None	None	None

**Table of Contents**

Pursuant to the Incentive Plan, the Company on March 9, 2006 granted to its employees, as a retention incentive, options to purchase 335,000 shares of its common stock exercisable at \$3.75 per share. On March 9, 2006, the Company also granted to certain key consultants, as a retention incentive, options to purchase 30,000 shares of its common stock exercisable at \$3.75 per share. Pursuant to the Director Plan, on March 9, 2006, the Company granted to each of its non-management directors, in consideration of their service on the Board of Directors in 2005, options to purchase shares of the Company's common stock, exercisable at \$3.75 per share. The grants ranged from 1,500 to 8,500 options per Director and totaled 34,000 stock options.

Members of the Board of Directors receive stock options for each Board and Committee meeting attended. The options are typically granted in the year following service. The Company expenses the value of stock options as earned. In the third quarter of 2006 Board members earned approximately 11,000 stock options. During the nine months ended September 30, 2006, the Directors have earned approximately 31,000 stock options.

The following table summarizes the stock option activity in the equity incentive plans from January 1, 2006 through September 30, 2006:

	Shares	Exercise Price Per Share	Weighted Average Exercise Price
Outstanding, January 1, 2006	2,675,354	\$ 1.90 5.80	\$ 3.57
Granted	399,000	3.75	3.75
Forfeited	(15,000)	3.75	3.75
Outstanding, September 30, 2006	3,059,354	\$ 1.90 5.80	\$ 3.60

The following tables summarize information about stock options outstanding at September 30, 2006:

Options Outstanding		Weighted		Options Exercisable		
		Average	Weighted			
		Remaining	Average	Number		
		Contractual	Exercise	of		
Exercise Price		Life (Years)	Price	Shares	Price	
\$ 1.90	\$ 2.82	427,000	7.59	\$ 2.34	183,667	\$ 2.42
\$ 2.92	\$ 4.05	2,547,354	4.62	\$ 3.75	2,202,354	\$ 3.75
\$ 5.16	\$ 5.80	85,000	.50	\$ 5.35	85,000	\$ 5.35
		3,059,354	4.92	\$ 3.60	2,471,021	\$ 3.71

As of September 30, 2006, there were 588,333 unvested options which will vest as follows: 71,667 in 2006, 236,667 in 2007, 165,001 in 2008 and 114,998 in 2009. Total expected unrecognized compensation cost related to such unvested options is \$809, which is expected to be recognized over a weighted average period of 1.2 years. As of September 30, 2006, there is no aggregate intrinsic value of outstanding options, and there is no aggregate intrinsic value of fully vested and exercisable options, based on the Company's closing common stock price of \$.82 as of September 30, 2006.

No cash was received from employees as a result of employee stock option exercises during the three and nine month periods ended September 30, 2006 and 2005 and \$149 during the cumulative period from inception to September 30, 2006. No options were exercised during the three or nine month periods ended September 30, 2006 and 2005 and the intrinsic value of options exercised for the cumulative period from inception was \$73.

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No options were granted during the three month periods ended September 30, 2006 and 2005. The weighted average grant date fair value for options granted during the nine month periods ended September 30, 2006 and 2005 and the cumulative period from inception to September 30, 2006 was \$3.75, \$2.79 and \$3.60, respectively. No options vested during the three month periods ended September 30, 2006 and 2005. The total fair value of options vested during the nine month periods ended September 30, 2006 and 2005 and the cumulative period from inception to September 30, 2006 was \$306, \$154 and \$9,327, respectively. During the three and nine month periods ended September 30, 2006 no and 15,000 options were forfeited, respectively. No options were forfeited in the three and nine month periods ended September 30, 2005.

Estimates of the fair value of equity awards will be affected by the future market price of the Company's common stock, as well as the actual results of certain assumptions used to value the equity awards. These assumptions include, but are not limited to, the related income tax impact, the expected volatility of the common stock, the number of stock options to be forfeited and exercised by employees, and the expected term of options granted.

**Table of Contents**

As noted above, the fair value of stock options is determined by using the Black-Scholes option pricing model and applying the multiple-option valuation approach to the stock option valuation. In general employee options vest over a period of three years. Board of Director and other options vest upon grant. For all options granted since January 1, 2006 the Company has used five years as the option term which represents the life of options granted. Prior to January 1, 2006 the Company used three years as the option term.

The volatility of the common stock is estimated using a combination of historical and implied volatility, as discussed in Staff Accounting Bulletin No. 107. By using this combination, the Company is taking into consideration the historical realized volatility, as well as factoring in estimates of future volatility that the Company believes will differ from historical volatility as a result of the market performance of the common stock, the volume of activity of the underlying shares, the availability of actively traded common stock options, and overall market conditions.

The risk-free interest rate used in the Black-Scholes option pricing model is determined by looking at historical U.S. Treasury zero-coupon bond issues with terms equal to the expected terms of the equity awards. In addition, an expected dividend yield of zero is used in the option valuation model, because the Company does not expect to pay any cash dividends in the foreseeable future. Lastly, in accordance with SFAS No. 123R, the Company is required to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. In order to determine an estimated pre-vesting option forfeiture rate, the Company used historical forfeiture data. This estimated forfeiture rate has been applied to all unvested options outstanding as of January 1, 2006 and to all options granted since January 1, 2006. Therefore, stock-based compensation expense is recorded only for those options that are expected to vest.

**3. ACCRUED EXPENSES**

Accrued expenses consist of the following:

	September 30,	December 31,
	2006	2005
Legal and accounting fees	\$ 256	\$ 188
Scientific and clinical fees	299	578
Accrued payroll and vacation	117	296
Other	9	23
<b>Total</b>	<b>\$ 681</b>	<b>\$ 1,085</b>

**4. CONVERTIBLE DEBT INSTRUMENT AND WARRANT LIABILITIES**

In February 2006, the Company issued \$10,000 in aggregate principal amount of convertible debentures (the *Debentures*) together with warrants to purchase approximately 1,490,000 shares of the Company's common stock (the *Warrants*). Additionally, in connection with issuance of the Debentures and Warrants, the placement agent received a fee of \$550 and approximately 149,000 fully vested warrants (the *Placement Agent Warrants*) to purchase shares of the Company's common stock. Net proceeds were approximately \$9,300, net of approximately \$700 in direct transaction costs, including the placement agent fee.

*Features of the Convertible Debt Instrument and Warrants*

The Debentures are convertible into 2,985,075 shares of the Company's common stock at the option of the holder at any time prior to maturity at a conversion price of \$3.35 per share, subject to adjustment for certain events described below. The Warrants are exercisable over a five year period from August 15, 2006 through August 14, 2011 at \$3.35 per share.

The Debentures bear interest at 7% and are required to be redeemed in eighteen equal monthly installments beginning in August 2006 and continuing through January 2008. Interest is payable monthly beginning in July 2006. Each redemption installment and accrued interest may be settled in cash or in shares of common stock at the option of the Company. The number of shares deliverable under the share-settlement option is determined based on the lower of (a) \$3.35 per share, as adjusted pursuant to the terms of the Debentures or (b) 90% applied to the average of the lowest five volume-weighted-average trading prices in a twenty day period immediately preceding each share settlement. If the



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share-settlement option is elected by the Company, the Company is required to make an estimated payment in shares approximately 30 days prior to the scheduled maturity date.

In the event of default, as defined in the Debentures, all amounts due and outstanding thereunder shall become, at the option of the holders, immediately due and payable in cash, in an amount that equals the sum of (i) the greater of (a) 130% of the outstanding balance plus all accrued and unpaid interest or (b) the conversion value of the Debentures,

## Table of Contents

and (ii) all other amounts due in connection with the Debentures and associated agreements. Additionally, if a certain breach occurs under a related registration rights agreement, the Company will be required to pay, as liquidated damages, 2% per month of the outstanding balance of the Debentures, until such default is cured, up to a maximum of 24 months. Events of default include circumstances in which the Company either fails to have a registration statement for shares into which the Debentures can be converted be declared effective by the SEC within 180 days of the issuance date of the Debentures or that the registration statement's effectiveness lapses for any reason. On March 29, 2006, the SEC declared effective the Company's registration statement on Form S-3, which registered 7,300,000 shares of the Company's common stock in connection with the Debentures and related Warrants and Placement Agent Warrants.

As required by the transaction documents for these securities, the Company sought and on May 25, 2006 received approval from its shareholders to issue shares necessary to satisfy the Company's obligations under the Debenture and Warrants and Placement Agent Warrants.

The conversion price of the Debentures and exercise price of the Warrants are each subject to certain anti-dilution protections, including for stock splits, stock dividends, change in control events and dilutive issuances of common stock or common stock equivalents, such as stock options, at an effective price per share that is lower than the then conversion price. In the event of a dilutive issuance of common stock or common stock equivalents, the conversion price and exercise price would be reduced to equal the lower price per share of the subsequent transaction.

### *Accounting for the Convertible Debt Instrument and Warrants*

The Company has determined that the Debentures constitute a hybrid instrument that has the characteristics of a debt host contract containing several embedded derivative features that would require bifurcation and separate accounting as a derivative instrument pursuant to the provisions of SFAS 133. Accounting for Derivative Instruments and Hedging Activities (SFAS 133). As permitted by SFAS No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140, the Company has irrevocably elected to initially and subsequently measure the Debentures in their entirety at fair value with changes in fair value recognized as either a gain or loss. Such changes are reflected in the statement of operations under the caption Change in fair value of convertible debt instrument and warrant liabilities.

Upon issuance, the Warrants and Placement Agent Warrants did not meet the requirements for equity classification set forth in EITF Issue No. 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in a Company's Own Stock, because such warrants (a) must be settled in registered shares and (b) are subject to substantial liquidated damages if the Company is unable to maintain the effectiveness of the resale registration of the shares. Therefore such Warrants are required to be accounted for at fair value as freestanding derivative instruments pursuant to the provisions of SFAS 133. Changes in fair value are recognized as either a gain or loss in the statement of operations under the caption Change in fair value of convertible debt instrument and warrant liabilities.

Upon issuance of the Debentures and Warrants, the Company allocated proceeds received to the Debentures and the Warrants on a relative fair value basis. As a result of such allocation, the Company determined the initial carrying value of the Debentures to be \$7,747. The Debentures were immediately marked to fair value, resulting in a derivative liability in the amount of \$9,126 and a charge to Change in fair value of convertible debt instrument of \$2,079.

Upon issuance, the Company allocated \$2,253 of the initial proceeds to the Warrants and immediately marked them to fair value resulting in a derivative liability of \$2,654 and a charge to change in fair value of convertible debt instrument and warrant liabilities of \$401. The Company paid approximately \$700 in cash transaction costs and incurred another \$266 in costs based upon the fair value of the Placement Agent Warrants. Such costs were expensed immediately as part of fair value adjustments required in connection with the convertible debt instrument and the Company's irrevocable election to initially and subsequently measure the Debentures at fair value with changes in fair value recognized in earnings.

The debt discount in the amount of \$2,253 (resulting from the allocation of proceeds) is being amortized to interest expense using the effective interest method over the expected term of the Debentures. The Company amortized \$382 and \$1,384 of this amount in the three and nine month periods ended September 30, 2006 with a corresponding increase in the carrying value of the debenture. Of this amount \$382 and \$1,048 in the three and nine months period ended September 30, 2006, respectively, was charged to interest expense. An additional \$138 and \$380 in interest expense was recorded during the three and nine months ended September 30, 2006 respectively based upon the 7% coupon rate.

**Table of Contents**

A summary of changes in the Debenture, Warrants and Placement Agent Warrants is as follows:

	Fair Value of		
	Fair Value of	Warrant	
	Debenture	Liabilities	Total
Allocation of initial proceeds	\$ 7,747	\$ 2,253	\$ 10,000
Cash transaction costs	(700)		(700)
Initial fair value adjustment	2,079	667	2,746
February 14, 2006	\$ 9,126	\$ 2,920	\$ 12,046
Amortization of debt discount	239		239
Fair value adjustment	1,680	860	2,540
Balance March 31, 2006	\$ 11,045	\$ 3,780	\$ 14,825
Conversions, at net carrying amount(1)	(1,726)		(1,726)
Redemptions, at net carrying amount(2)	(637)		(637)
Amortization of debt discount	427		427
Fair value adjustment	(526)	(928)	(1,454)
Balance June 30, 2006	\$ 8,583	\$ 2,852	\$ 11,435
Redemptions, at net carrying amount(3)	(1,157)		(1,157)
Amortization of debt discount	382		382
Fair value adjustment	(744)	(2,389)	(3,133)
Balance September 30, 2006	\$ 7,064	\$ 463	\$ 7,527

(1) Represents conversions of principal value of \$1,575

(2) Represents prepayment in common stock of August 1, 2006 scheduled maturity of principal value of \$500

(3) Represents prepayment in common stock of September 1 and October 1, 2006 scheduled maturity of principal value of \$500 each

**5. EARNINGS PER SHARE**

Basic loss per share is based on the weighted-average number of common shares outstanding during each period. Diluted loss per share is based on basic shares as determined above plus the incremental shares that would be issued upon the assumed exercise of in-the-money stock options and warrants using the treasury stock method and convertible debenture using the if-converted method. The computation of diluted net loss per share does not assume the issuance of common shares that have an anti-dilutive effect on net loss per share. For the three and nine month periods ended September 30, 2006 and 2005, all stock options and warrants were excluded from the computation of diluted net income (loss) per share. For the three months ended September 30, 2006, convertible debentures were included in the computation of diluted net income per share. For the three months ended September 30, 2005 and for the nine months ended September 30, 2006 and 2005, convertible debentures were excluded from the computation of diluted net loss per share.

	Three Months Ended		Nine Months Ended	
	September 30, 2006	2005	September 30, 2006	2005
Net Income (Loss)-basic	\$ 720	\$ (1,680)	\$ (7,773)	\$ (4,795)
Interest expense adjustment related to convertible debenture	520			
Fair value adjustment related to convertible debenture	(744)			

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Net Income (Loss)-diluted \$ 496 \$ (1,680) \$ (7,773) \$ (4,795)

	<b>Three Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>	<b>September 30,</b>	<b>September 30,</b>	<b>September 30,</b>
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Weighted average common shares outstanding-basic	28,600,489	27,315,411	27,884,020	27,315,411
Incremental shares related to convertible debenture	1,825,912			
<b>Weighted average common shares outstanding-diluted</b>	<b>30,426,401</b>	<b>27,315,411</b>	<b>27,884,020</b>	<b>27,315,411</b>
<b>Earnings Per Share</b>				
-Basic	0.03	(0.06)	(0.28)	(0.18)
-Diluted	0.02	(0.06)	(0.28)	(0.18)

**Table of Contents**

**6. CONTINGENCIES**

In January 2004, Dr. Platt, the Company's Chairman and Chief Executive Officer, filed a lawsuit in Massachusetts Superior Court against GlycoGenesys, Inc. for various claims including breach of contract. In February 2004, GlycoGenesys filed a counterclaim lawsuit against the Company and Dr. Platt alleging tortious interference and misappropriation of proprietary rights. On February 2, 2006, GlycoGenesys filed a voluntary petition in bankruptcy for protection under Chapter 11 of the U.S. Bankruptcy Code, as a result of which the counterclaim litigation is stayed. On June 1, 2006, the bankruptcy court approved a motion by GlycoGenesys to convert the proceeding to Chapter 7 liquidation. On October 23, 2006, the judge issued an order allowing the liquidation sale of certain GlycoGenesys assets to Marlborough Research and Development, Inc. As a part of the sale, Marlborough Research and Development, Inc. must pay cure costs incurred by Pro-Pharmaceuticals in the amount of approximately \$200 as reimbursement of legal expenses related to patent defense costs.

Pursuant to Board approval, the Company has agreed to indemnify Dr. Platt for the expenses of his defense of the counterclaims, some of which may be recoverable under insurance. For the three months ended September 30, 2006, the Company incurred no expenses and for the nine months ended September 30, 2006 the Company incurred approximately \$11 of expenses in connection with this defense. Through September 30, 2006 the Company has incurred cumulative expenses of approximately \$438 in connection with this defense. No amount, if any, potentially recoverable from the insurance policy has been recorded at September 30, 2006.

In the ordinary course of business, the Company may from time to time be involved in other legal matters that in the Company's estimation will not have a material adverse impact on it. The Company records accruals for such contingencies to the extent that the Company concludes that their occurrence is probable and the related damages are estimable.

**7. SUBSEQUENT EVENTS**

On October 1, 2006, the Company issued 372,053 shares of common stock to satisfy redemptions in accordance with the terms of the convertible debenture agreement. Additionally, the Company made the November 1, 2006 monthly debenture payment of principal and interest in cash. The Company intends to make the December 1, 2006 monthly payment of principal and interest in cash.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (dollar amounts in thousands)**

In addition to historical information, the following Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements as defined under federal securities laws and is subject to the safe harbor created therein for forward-looking statements. Such statements include, but are not limited to, statements concerning our anticipated operating results, research and development, clinical trials, and financial resources, and can be identified by use of words such as, for example, anticipate, estimate, expect, project, intend, plan, believe and would, should, could or may. Forward-looking statements are based on current expectations, estimates and projections of the industry and markets in which Pro-Pharmaceuticals operates, and management's beliefs and assumptions. These statements are not guarantees of future performance and involve certain known and unknown risks and uncertainties that could cause actual results to differ materially from those expressed or implied by such statements. Such risks and uncertainties are related to, without limitation, our early stage of development, our dependence on outside capital, uncertainties of our technology and clinical trials, intellectual property litigation, risk of default on our securities, uncertainties of regulatory approval requirements for our products, competition and stock price volatility in the biotechnology industry, limited trading volume for our stock, concentration of ownership of our stock, and other risks detailed herein and from time to time in our SEC reports. The following discussion should be read in conjunction with the accompanying consolidated financial statements and notes thereto of Pro-Pharmaceuticals appearing elsewhere herein.

**Overview**

We are a development-stage company engaged in research and development of carbohydrate based therapeutic compounds. We believe our carbohydrate-based compounds offer numerous opportunities to provide advanced disease treatments. Our initial focus is on the target delivery of chemotherapy drugs for the treatment of cancer. We believe our initial carbohydrate compound DAVANA<sup>®</sup> may increase the body's tolerance to these toxic drugs by targeting the delivery directly to cancerous cells and increasing the efficacy, thereby creating a preferable treatment to existing oncology regimens. For additional information, please see Item 1. Business - Business of Pro-Pharmaceuticals included in our Annual Report on Form 10-K for the year ended December 31, 2005.

All of our drug candidates are in preclinical and clinical development. We currently have one drug candidate DAVANA<sup>®</sup> in clinical development. In general, in order to commercialize our present and future drug candidates, we are required to successfully complete preclinical studies and clinical trials and obtain regulatory approvals. The requirements for regulatory approval include:

preclinical toxicology, pharmacology and metabolism studies, as well as in-vivo efficacy studies in relevant animal models of disease;

## **Table of Contents**

manufacturing of drug products for use in preclinical studies and clinical trials and ultimately for commercial supply;

submission of the results of preclinical studies and information regarding manufacturing and control and proposed clinical protocol to the U.S. Food and Drug Administration (FDA) in an investigational new drug application (IND), or similar filings with regulatory agencies outside the United States;

conduct of clinical trials designed to provide data and information regarding the safety and efficacy of the product candidate in humans; and

submission of all the results of testing to the FDA in a new drug application (NDA), or similar filings with regulatory agencies outside the United States.

Upon approval by the appropriate regulatory authorities we may commence commercial marketing and distribution of the product. This process typically takes several years to complete and requires the expenditure of substantial resources. Any delay in obtaining or failure to obtain required approvals will materially adversely affect our ability to generate revenues from commercial sales relating to our drug candidates. We do not expect to file an NDA for a drug candidate before 2008. We anticipate our source of funding for the next several years to come from either financing transactions or collaborations with other pharmaceutical companies.

We are devoting substantially all of our efforts toward product research and development, and raising capital. We have no source of revenue and have incurred significant losses to date. We have incurred net losses of \$34,203 for the cumulative period from inception through September 30, 2006. Our losses have resulted principally from costs associated with research and development expenses, including clinical trial costs, general and administrative activities and costs related to our debt financings, including interest and changes in debt carried at fair value. As a result of planned expenditures for future research, discovery, development and commercialization activities, we expect to incur additional operating losses for the foreseeable future.

Through September 30, 2006, we have raised approximately \$35,930 in capital principally through the sale and issuance of common stock, common stock warrants and debt securities in public and private offerings. From inception through September 30, 2006, we used cash of \$26,959 for our operations. At September 30, 2006, we had \$8,125 of cash and cash equivalents and a certificate of deposit available to fund future operations, which we believe is sufficient to fund our operations through at least June 2007.

Because we lack revenue and must continue our research and development, we must continually identify new sources of capital and complete financing transactions in order to continue our business. We must continually monitor the monthly burn rate of our capital resources.

## **Results of Operations**

### ***Three Months Ended September 30, 2006 Compared to Three Months Ended September 30, 2005***

*Research and Development Expenses.* Research and development expenses were \$863 during the three months ended September 30, 2006 as compared to \$859 incurred during the three months ended September 30, 2005. We generally categorize research and development expenses as either direct external expense, comprised of amounts paid to third party vendors for services, or all other expenses, comprised of employee payroll and general overhead allocable to research and development. We subdivide external expenses between clinical programs and preclinical activities. We consider a clinical program to have begun upon acceptance by the FDA, or similar agency outside of the United States, to commence a clinical trial in humans, at which time we begin tracking expenditures by the product candidate. We currently have one product candidate DAVANAT<sup>®</sup> in clinical trials. Clinical program expenses comprise payments to vendors related to preparation for, and conduct of, all phases of the clinical trial, including costs for drug manufacture, patient dosing and monitoring, data collection and management, oversight of the trials and reports of results. Pre-clinical expenses comprise all research and development amounts incurred before human trials begin, including payments to vendors for services related to product experiments and discovery, toxicology, pharmacology, metabolism and efficacy studies, as well as manufacturing process development for a drug candidate.

**Table of Contents**

Our research and development expenses for the three months ended September 30, 2006 as compared to the three months ended September 30, 2005 were as follows:

	Three Months Ended	
	September 30, 2006	2005
Direct external expenses		
Clinical programs	\$ 515	\$ 463
Pre-clinical activities	111	267
All other research and development expenses	237	129
	\$ 863	\$ 859

Clinical trial expenses increased by approximately \$52. Approximately \$440 of this increase was related to initiating the Phase II line 1, biliary duct cancer, the Phase III, line 2, colorectal cancer and the Phase II line 1, colorectal cancer trials. This was offset by a \$391 reduction in the Phase II, line 3/4 DAVANAT<sup>®</sup>/5-FU colorectal cancer trial which is concluding. Pre-clinical activities decreased by \$156 due to lower research activities and a reclassification of stock based compensation expense, for stock options previously issued, out of Pre-clinical activities and into All other research and development expenses of \$62. Other research and development costs increased by approximately \$108. Of this amount \$62 is due to the reclassification of stock compensation expense out of Pre-clinical activities. An additional \$34 is due to third quarter stock compensation expense for stock options previously issued. Payroll expense increased due principally to the addition, in January 2006, of our Chief Scientist and to a lesser degree, other personnel. These amounts were largely offset by the reversal of an incentive compensation accrual. In September 2005 we submitted an IND to the FDA for an additional Phase II clinical trial of DAVANAT<sup>®</sup>/5-FU to treat line 1, bile duct cancer patients. We also received clearance from the EMEA (European Medicines Agency) to begin a Phase III, line 2, colorectal cancer trial of DAVANAT<sup>®</sup>/5-FU in combination with other chemotherapy drugs. In September 2006 we temporarily delayed dosing of patients in this trial so that we may focus our resources on the two Phase II trials as they present an opportunity to provide results more quickly and more cost effectively. These trials are designed to test the efficacy of DAVANAT<sup>®</sup> for specific cancer indications in combination with chemotherapeutic drugs. We expect that the new clinical trials, the addition of our Chief Scientist, and the implementation of expensing of our stock options will cause our research and development expenses to increase in 2006 as compared to 2005.

Both the time required and costs we may incur in order to commercialize a drug candidate that would result in material net cash inflow are subject to numerous variables, and hence we are unable at this stage of our development to forecast useful estimates. Variables that make estimates difficult include the number of clinical trials we may undertake, the number of patients needed to participate in the clinical trial, patient recruitment uncertainties, trial results as to the safety and efficacy of our product, and uncertainties as to the regulatory agency response to our clinical trial data prior to receipt of marketing approval. Moreover, the FDA or other regulatory agencies may suspend clinical trials if we or an agency believes patients in the trial are subject to unacceptable risks, or finds deficiencies in the conduct of the clinical trial. Delays or rejections may also occur if governmental regulation or policy changes during our clinical trials or in the course of review of our clinical data. Please see

Risks Related to Pro-Pharmaceuticals and Risks Related to the Drug Development Industry included in the Annual Report on Form 10-K for the year ended December 31, 2005 for additional risks and other factors that make estimates difficult at this time. Due to these uncertainties, accurate and meaningful estimates of the ultimate cost to bring a product to market, the timing of costs and completion of our program and the period during which material net cash inflows will commence are unavailable at this time.

*General and Administrative Expenses.* General and administrative expenses were \$1,066 during the three months ended September 30, 2006, or a 26% increase, as compared to \$845 incurred during the three months ended September 30, 2005. General and administrative expenses consist primarily of salaries including stock based compensation, legal and accounting fees, insurance, investor relations, business development and other office related expenses. Of the \$221 increase, approximately \$46 was the result of expensing employee stock options under the fair value method commencing on January 1, 2006 as required by SFAS 123R. This was offset by the reversal of an incentive compensation accrual. The remainder of the increase was due principally to expenses associated with our February 14, 2006 convertible debenture. We expect our general and administrative expenses to increase over 2005 levels due to implementation of SFAS 123R and expenses associated with our February 14, 2006 debentures and related warrants.

*Other Income and Expense.* Other income and expense for the three months ended September 30, 2006 was \$2,649 of income compared to \$25 of income for the three months ended September 30, 2005. The increase is related to our convertible debt instrument and warrant liabilities of which \$3,133 is income related to fair value accounting, offset by \$520 of interest expense related to the convertible debenture. The \$520 of interest includes \$382 of debt discount amortization and \$138 of interest expense related to the 7% coupon rate.





**Table of Contents**

*Nine Months Ended September 30, 2006 Compared to Nine Months Ended September 30, 2005*

*Research and Development Expenses.* Research and development expenses were \$2,315 during the nine months ended September 30, 2006, as compared to \$2,292 incurred during the nine months ended September 30, 2005. Please see explanation above contained in the three month analysis for a description of what is included in research and development expenses.

**Table of Contents**

Our research and development expenses for the nine months ended September 30, 2006, as compared to the nine months ended September 30, 2005 were as follows:

	Nine Months Ended	
	September 30, 2006	2005
Direct external expenses		
Clinical programs	\$ 1,196	\$ 1,435
Pre-clinical activities	466	461
All other research and development expenses	653	396
	\$ 2,315	\$ 2,292

Clinical trial costs decreased by approximately \$239. This was due to a \$1,110 reduction in expenses related to the Phase II, line 3/4 DAVANAT®/5-FU Colorectal Cancer trial which is concluding and the Phase I line 3/4 DAVANAT®/5-FU clinical trial for cancer patients with all solid tumors. This was offset by an increase of \$871 associated with initiating the Phase II, line 1 bile duct cancer, the Phase III, line 2 Colorectal Cancer trial, and the Phase II, line 1, Colorectal Cancer trial. Pre-clinical activities decreased due to lower manufacturing costs offset by an increase in research initiatives. Other research and development costs increased by approximately \$257 due principally to the addition, in January 2006, of our Chief Scientist and, to a lesser degree, stock based compensation expense of \$96 largely related to the fair value method as required by SFAS 123R.

*General and Administrative Expenses.* General and administrative expenses were \$3,437 during the nine months ended September 30, 2006, an increase of 32% as compared to \$2,594 incurred during the nine months ended September 30, 2005. Please see explanation above contained in the three month analysis for a description of what is included in general and administrative expenses. The increase of \$843 includes an increase in legal expenses of approximately \$262 primarily related to defend the claims against our intellectual property asserted by GlycoGenesys and matters related to the bankruptcy of GlycoGenesys. Approximately \$194 was the result of expensing employee stock options under the fair value method commencing on January 1, 2006 as required by SFAS 123R. The remainder of the increase was due principally to expenses associated with our February 14, 2006 debentures and related warrants. We expect our general and administrative expenses to increase over 2005 levels due primarily to implementation of SFAS 123R and expenses associated with our February 14, 2006 debentures and related warrants.

*Other Income and Expense.* Other income and expense for the nine months ended September 30, 2006 was \$2,021 of expense compared to \$91 of income for the nine months ended September 30, 2005. The decrease is related to our convertible debt instrument and warrant liabilities of which \$699 is related to fair value accounting and \$1,428 is related to interest expense. The \$1,428 of interest includes \$1,048 of debt discount amortization and \$380 of interest expense related to the 7% coupon rate.

**Liquidity and Capital Resources**

As described above in the Overview and elsewhere in this Quarterly Report on Form 10-Q, we are in the development stage and have not generated any revenues. Since our inception on July 10, 2000, we have financed our operations from proceeds of public and private offerings of debt and equity. As of September 30, 2006, we raised a total of \$35,930 from these offerings and had \$8,125 of available cash and cash equivalents and a certificate of deposit.

Net cash used in operations increased by \$895 to \$5,476 for the nine months ended September 30, 2006 from \$4,581 for the nine months ended September 30, 2005. \$184 of this amount is due to increases in working capital needs and the remainder is due to cash used to fund operating expenses as more fully described above.

Net cash used in investing activities was \$5,165 for the nine months ended September 30, 2006 compared to \$121 for the nine months ended September 30, 2005. The increase in investing activities consists primarily of placing \$5,000 of the convertible debenture proceeds in a certificate of deposit with a one time penalty-free withdrawal provision. The certificate of deposit matures on March 14, 2007. Fixed asset expenditures increased by \$76 due principally to the move of the company's offices to new leased space. This was offset in part by a reduction in capitalized patent costs of \$32.

Net cash provided by financing activities in the first nine months of 2006 was \$9,300 which we raised in a private placement of \$10,000, 7% convertible debentures and related common stock purchase warrants. As a result of the financing we incurred \$700 of transaction costs,

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comprised of \$550 paid as a fee for services to the placement agent, and the balance for fees for related legal and accounting services. Our resale registration of the shares of common stock underlying the debentures and warrants became effective on March 29, 2006. There were no financing activities in the first nine months of 2005.

**Table of Contents**

We believe that our cash and cash equivalents and certificate of deposit at September 30, 2006 totaling of \$8,125 will be sufficient to enable us to meet our operating requirements through at least June 2007. We will require more cash to fund our operations over the long-term and believe we will be able to obtain additional financing. However, there can be no assurance that we will be successful in obtaining such new financing or, if available, that such financing will be on terms favorable to us.

**Payments Due Under Contractual Obligation**

The following table summarizes the payments due under our contractual obligations at September 30, 2006, and the effect such obligations are expected to have on liquidity and cash flow in future periods:

Contractual Obligations	Total	Payments due by period			
		Less than 1 year	1-3 years	3-5 years	More than 5 years
Long-term debt	\$ 7,240	\$ 5,436	\$ 1,804		
Operating leases	1,255	249	767	239	
<b>Total payments due under contractual obligations</b>	<b>\$ 8,495</b>	<b>\$ 5,685</b>	<b>\$ 2,571</b>	<b>\$ 239</b>	<b>\$</b>

Long-term debt consists of scheduled principal and interest payments on our 7% convertible debentures. Remaining principal of \$6,925 is payable in monthly installments, through January 1, 2008. Approximately \$5,147 of principal payments are due in less than one year and \$1,778 is due in 1-3 years. Interest accrues at the rate of 7% and is payable monthly. Total interest due in less than one year is approximately \$289 and in 1-3 years is approximately \$26. Principal and interest may be paid, at our option, in cash or shares of our common stock. Because investors may convert principal into common stock, at any time, at their option, the timing of principal and interest payments may accelerate relative to this schedule.

On May 1, 2006 we entered into an operating lease for office space. The lease extends for five years and terminates on June 30, 2011. The lease provides for annual base rental payments of \$235 in the first year increasing in each subsequent lease year to \$244, \$253, \$263 and \$273 respectively. In addition to base rental payments, we are responsible for our pro-rata share of increases in the operating expenses for the building after calendar year 2006 and taxes for the building after fiscal year 2007. We have the right to extend the term of the lease for an additional five year period at the prevailing market rate at the time of exercise. In connection with this new office space lease, a commercial bank has issued a letter of credit collateralized by cash we have on deposit with the bank of approximately \$59. Additionally, we have a non-cancellable lease for a car which expires in October of 2007.

We have engaged outside vendors for certain services associated with our clinical trials. These services are generally available from several providers and, accordingly, our arrangements are typically cancellable on 30 days notice.

**Off-Balance Sheet Arrangements**

We have not created, and are not party to, any special-purpose or off-balance sheet entities for the purpose of raising capital, incurring debt or operating parts of our business that are not consolidated into our financial statements. We do not have any arrangements or relationships with entities that are not consolidated into our financial statements that are reasonably likely to materially affect our liquidity or the availability of capital resources.

**Application of Critical Accounting Policies and Estimates**

The preparation of consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, including those related to intangible assets, income taxes, accrued expenses, stock-based compensation, convertible debt instrument and warrant liabilities contingencies and litigation. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

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Critical accounting policies are those policies that affect our more significant judgments and estimates used in preparation of our consolidated financial statements. We believe our critical accounting policies include our policies regarding stock-based compensation, accrued expenses, income taxes and convertible debt instrument and warrant liabilities. For a more detailed discussion the first three of our critical accounting policies, please refer to our 2005 Annual Report on Form 10-K. A discussion of our derivative instrument accounting policy is detailed below.

## **Table of Contents**

***Convertible debt instrument and warrant liabilities.*** We account for our convertible debentures and associated warrants in accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments* an amendment of FASB Statements No. 133 and 140. Our convertible debentures include features that qualify as embedded derivatives, such as (i) the holders' conversion option, (ii) our option to settle the debentures at the scheduled maturity dates in cash or shares of our registered common stock, and (iii) premiums and penalties we would be liable to pay in the event of default. As permitted under SFAS No. 155, we elected to initially and subsequently measure the convertible debentures in their entirety at fair value with changes in fair value recognized as either a gain or loss. We made this election because we determined the aggregate fair value of the convertible debenture to be more meaningful in the context of our financial statements than if separate fair values were assigned to each of the multiple embedded instruments contained within such debentures. We believe the early adoption of SFAS No. 155 had no impact upon our financial position, results of operations or cash flows, but rather served to simplify the disclosures related to our convertible debentures that would otherwise have been required under SFAS No. 133 and related accounting pronouncements.

We record interest expense under our convertible debentures based on our 7% coupon rate, as well as the amortization of the debt discount, which we compute using the effective interest method. The debt discount represents the difference between our gross proceeds of \$10,000 and the fair value of the convertible debt upon issuance, after separately valuing the investor warrants and the convertible debentures on a relative fair value basis. By amortizing the debt discount to interest expense, rather than recognizing it as a change in fair value of convertible debt instrument and warrants, which is separate line item in our statement of operations, we believe our interest expense line item more appropriately reflects the cost of debt associated with our convertible debentures.

We determined the fair values of our convertible debentures, investor warrants and placement agent warrants in consultation with valuation specialists, using valuation models we consider to be appropriate. Our stock price has the most significant influence on the fair value of our convertible debentures and our warrants. An increase in our common stock price would cause the fair values of both convertible debentures and warrants to increase, because the conversion and exercise prices, respectively, of such instruments are fixed at \$3.35 per share, and result in a charge to our statement of operations. A decrease in our stock price would likewise cause the fair value of the convertible debentures and the warrants to decrease and result in a credit to our statement of operations. If the price of our common stock were to decline significantly, however, the decrease in the fair value of the convertible debentures would be limited by the instrument's debt characteristics. Under such circumstances, our estimated cost of capital would become another significant variable affecting the fair value of the convertible debentures.

### **New Accounting Pronouncements**

In June 2006, the Financial Accounting Standards Board issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (the Interpretation). This Interpretation clarifies the accounting for uncertainty in income taxes recognized in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. This Interpretation prescribes a more-likely-than-not recognition threshold that a tax position will be sustained upon examination and a measurement attribute for the financial statement recognition of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. This Interpretation is effective for fiscal year beginning after December 15, 2006. The cumulative effect of applying the provisions of this Interpretation shall be reported as an adjustment to the opening balance of retained earnings in 2007. We are currently evaluating the impact of the Interpretation on our consolidated financial statements.

In September 2006, the SEC issued staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Qualifying Misstatements in Current Year Financial Statements* (SAB 108). SAB 108 provides guidance on how prior year misstatements should be taken onto consideration when quantifying misstatements in current year financial statements for purposes of determining whether the current year's financial statements are materially misstated. We will be required to adopt SAB 108 in the fourth quarter of fiscal year 2006. We do not anticipate the adoption of SAB 108 will have a material impact on our consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS No. 157). SFAS No. 157 clarifies the principle that fair value should be based on the assumptions market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. Under the standard, fair value measurements would be separately disclosed by level within the fair value hierarchy. We will be required to adopt SFAS No. 157 in the first quarter of fiscal year 2008. We are currently evaluating the requirements of SFAS No. 157 and have not yet determined the impact, if any, on our consolidated financial statements.

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

Market risk represents the risk of loss that may impact our financial position, operating results or cash flows due to changes in the U.S. interest rates. The primary objective of our investment activities is to preserve cash until it is required to fund operations. To minimize risk, we maintain our portfolio of cash and cash equivalents in operating bank accounts and money market funds. Since our investments are short-term in duration, we believe that we are not subject to any material market risk exposure. As of September 30, 2006, we had \$6,925 of outstanding convertible

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debentures with an interest rate fixed at 7%. We account for the convertible debentures and warrant liabilities on a fair value basis, and changes in share price and market interest rates will affect our earnings but will not affect our cash flows.

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

Our management, with the participation of the Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in the SEC rules promulgated under the Securities Exchange Act of 1934, as amended (Exchange Act)) as of September 30, 2006. We have concluded that certain controls and procedures were not effective at September 30, 2006. The controls related to the recording of adjustments to the fair value of our convertible debentures were not designed to provide reasonable assurance that the convertible debentures would be accurately presented in all material respects in the financial statements. The error resulting from this material weakness in internal control occurred in September and has been corrected in the financial statements presented in this Form 10-Q. We have instituted additional procedures related to the foregoing, including tracing journal entry support to source data and retesting fair value calculations that are used as the basis for recording adjustments to the convertible debenture balances. Such additional procedures will be performed by a person not involved with the original journal entry preparation.

No change in our internal control over financial reporting (as defined in the SEC rules promulgated under the Exchange Act) occurred during the quarter ended September 30, 2006 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.



**Table of Contents****PART II OTHER INFORMATION****Item 1. Legal Proceedings (dollar amounts in thousands)**

In January 2004, Dr. Platt, our Chairman and Chief Executive Officer, filed a lawsuit in Massachusetts Superior Court against GlycoGenesys, Inc. for various claims including breach of contract. In February 2004, GlycoGenesys filed a counterclaim lawsuit against us and Dr. Platt alleging tortious interference and misappropriation of proprietary rights. On February 2, 2006, GlycoGenesys filed a voluntary petition in bankruptcy for protection under Chapter 11 of the U.S. Bankruptcy Code, as a result of which the counterclaim litigation is stayed. On June 1, 2006, the bankruptcy court approved a motion by GlycoGenesys to convert the proceeding to Chapter 7 liquidation. On October 23, 2006, the judge issued an order allowing the liquidation sale of certain GlycoGenesys assets to Marlborough Research and Development, Inc. As a part of the sale, Marlborough Research and Development, Inc. must pay cure costs to us in the amount of approximately \$200 as reimbursement of legal expenses related to patent defense costs.

Pursuant to Board approval, we have agreed to indemnify Dr. Platt for the expenses of his defense of the counterclaims, some of which may be recoverable under insurance. For the three months ended September 30, 2006, we incurred no expenses and for the nine months ended September 30, 2006 we incurred approximately \$11 of expenses in connection with this defense. Through September 30, 2006 we have incurred cumulative expenses of approximately \$438 in connection with this defense. No amount, if any, potentially recoverable from the insurance policy has been recorded at September 30, 2006.

**Item 1A. Risk Factors (dollar amounts in thousands)**

Our 2005 Annual Report on Form 10-K includes a detailed discussion of our risk factors at Item 1A of Part I. The information presented below updates, and should be read in conjunction with, the risk factors and information disclosed in that Form 10-K.

***We Have Incurred Net Losses to Date and Depend on Outside Capital.*** Our accumulated deficit as of September 30, 2006 was \$34,203. We will need to continue to conduct significant research, development, testing and regulatory compliance activities which, together with projected general and administrative expenses, we expect will result in substantial operating losses for the next several years. Accordingly, we will not be generating sales or other revenue and will remain dependent on outside sources of financing during that time. If we are unable to raise funds from outside sources for our continuing operations, we may be adversely affected.

We may raise such capital through public or private equity financings, partnerships, debt financings, bank borrowings, or other sources. Additional funding may not be available on favorable terms or at all. If adequate funds are not otherwise available, we may need to significantly curtail operations. To obtain additional funding, we may need to enter into arrangements that require us to relinquish rights to certain technologies, products and/or potential markets. To the extent that additional capital is raised through the sale of equity, or securities convertible into equity, our equity holders may experience dilution of their proportionate ownership of the company.

***We Could Be Required to Make Substantial Cash Payments Upon an Event of Default Under Our Debentures.*** Our 7% Convertible Debentures provide for events of default including, without limitation, failure to timely make payments of principal, interest or other amounts due thereunder, failure to observe or perform any covenant or agreement set forth in the debentures or other material agreements to which we are a party, default on another credit agreement or facility evidencing of obligations in excess of \$250, ineligibility of our stock for listing or quotation on a trading market, lapse of effectiveness of the registration statement registering the shares underlying the Debentures and warrants, or inability of selling stockholders to offer and sell their shares in excess of certain blackout periods. If an event of default occurs, the outstanding principal, plus accrued and unpaid interest due thereon, and all other amounts due under each Debenture may become, at the holder's election, immediately due and payable in cash in an amount that is not less than the sum of (i) 130% of the outstanding principal plus accrued and unpaid interest and (ii) other amounts due to such holder. We would not be able to repay this amount without raising additional capital.

***Large Sales Could Reduce the Trading Price of Our Common Stock.*** We listed our common stock on the American Stock Exchange in September 2003, prior to which our stock traded on the OTC Bulletin Board. Based on varying trading volume to date, our stock could be considered thinly traded. In 2003 and 2004, on behalf of existing stockholders, we registered for re-sale approximately 14.65 million shares of our common stock, and approximately 3.61 million shares of stock issuable upon exercise of immediately exercisable warrants. On March 29, 2006 on behalf of the holders of our 7% Convertible Debentures and common stock purchase warrants, we registered for re-sale 7.3 million shares of common stock issuable upon conversion or redemption of, or as interest payments on, the Debentures and exercise of the warrants. The

**Table of Contents**

interest and principal are payable monthly commencing July 1, and August 1, 2006, respectively, in shares of common stock, subject to some restrictions. In general, shares of registered common stock may be re-sold into the public markets without volume or other restrictions. Large sales of our registered shares could place substantial downward pressure on the trading price of our common stock, particularly if the amount sold significantly exceeds the then-current trading volume of our stock.

**Item 6. Exhibits**

The exhibits listed in the Exhibit Index immediately preceding the exhibits are filed as part of this Quarterly Report on Form 10-Q.

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on November 13, 2006.

PRO-PHARMACEUTICALS, INC.

By: /s/ David Platt  
Name: David Platt, Ph.D.  
Title: Chief Executive Officer

/s/ Carl L. Lueders  
Name: Carl L. Lueders  
Title: Chief Financial Officer

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**Table of Contents**

**Exhibit**

<b>Number</b>	<b>Description of Document</b>
4.1*	Form of 7% Convertible Debenture issued February 14, 2006
4.2*	Form of Common Stock Purchase Warrant dated February 14, 2006
4.3*	Registration Rights Agreement, dated as of February 14, 2006, between Pro-Pharmaceuticals, Inc. and the investors named in a Securities Purchase Agreement dated such date between Pro-Pharmaceuticals, Inc. and the investors signatory thereto
10.1*	Securities Purchase Agreement, dated as of February 14, 2006, between Pro-Pharmaceuticals, Inc. and the investors signatory thereto
31.1**	Certification Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934
31.2**	Certification Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934
32.1***	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2***	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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\* Incorporated by reference to the Registrant's Current Report on Form 8-K filed February 15, 2006.

\*\* Filed herewith.

\*\*\* Furnished herewith and not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.