

UROPLASTY INC
Form 10KSB
June 29, 2006

Table of Contents

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-KSB**

**Annual Report Pursuant To Section 13 or 15(d) of the Securities Exchange Act of 1934
For the Fiscal Year Ended March 31, 2006**

Commission File No. 000-20989

UROPLASTY, INC.

(Name of Small Business Issuer in its Charter)

Minnesota

(State or other jurisdiction of
incorporation or organization)

41-1719250

(I.R.S. Employer
Identification No.)

2718 Summer Street NE

Minneapolis, Minnesota 55413-2820

(Address of principal executive offices)

(612) 378-1180

(Issuer's telephone number, including area code)

Securities registered under Section 12(g) of the Exchange Act: Common Stock, \$.01 par value (Title of class)
Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the Company was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES NO

Check if disclosure of delinquent filers in response to Item 405 of Regulation S-B is not contained in this form, and no disclosure will be contained, to the best of Company's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YES NO

Issuer's revenues for its most recent fiscal year: \$6,142,612

The aggregate market value of the voting stock held by non-affiliates computed by reference to the price at which the stock was sold or the average bid and asked prices of such stock as of June 1, 2006 was \$9,514,884.

The number of shares outstanding of the issuer's only class of common stock on June 1, 2006 was 6,961,206.

Documents Incorporated By Reference: Portions of the Company's Proxy Statement for its 2006 Annual Meeting of Shareholders (the Proxy Statement), are incorporated by reference in Part III.

Transitional Small Business Disclosure Format: YES NO

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

YES NO

TABLE OF CONTENTS

PART I

ITEM 1. DESCRIPTION OF BUSINESS

ITEM 2. DESCRIPTION OF PROPERTY

ITEM 3. LEGAL PROCEEDINGS

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

PART II

ITEM 5. MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

ITEM 7. FINANCIAL STATEMENTS

ITEM 8. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

ITEM 8A. CONTROLS & PROCEDURES

ITEM 8B. OTHER INFORMATION

PART III

ITEM 9. DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS; COMPLIANCE WITH SECTION 16(a) OF THE EXCHANGE ACT

ITEM 10. EXECUTIVE COMPENSATION

ITEM 11. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

ITEM 12. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

ITEM 13. EXHIBITS AND REPORTS

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

SIGNATURES

Employment Agreement

Business Loan Agreement

Financial Statements

List of Subsidiaries

Consent of Independent Registered Public Accounting Firm

Certification by the CEO Pursuant to Section 302

Certification by the CFO Pursuant to Section 302

Certification by the CEO Pursuant to Section 906

Certification by the CFO Pursuant to Section 906

Table of Contents

PART I

Uroplasty, Inc. may from time to time make written or oral **forward-looking statements**, including our statements contained in this report with the Securities and Exchange Commission and in our reports to stockholders, as well as elsewhere. Forward-looking statements are statements such as those contained in projections, plans, objectives, estimates, statements of future economic performance, and assumptions related to any of the foregoing, and may be identified by the use of forward-looking terminology, such as may, expect, anticipate, estimate, goal, comparable terminology. By their very nature, forward-looking statements are subject to known and unknown risks and uncertainties relating to our future performance that may cause our actual results, performance or achievements, or industry results, to differ materially from those expressed or implied in any such forward-looking statements. Forward-looking statements are contained in the Management's Discussion and Analysis or Plan of Operation and other sections of this report. Various factors and risks (not all of which are identifiable at this time) could cause our results, performance or achievements to differ materially from that contained in our forward-looking statements. We caution investors that any forward-looking statement contained herein or elsewhere is qualified by and subject to the warnings and cautionary statements contained above and in, particular, in the Risk Factors discussion contained in the Description of Business section of this report.

We do not undertake and assume no obligation to update any forward-looking statement that we may make from time to time.

ITEM 1. DESCRIPTION OF BUSINESS

Overview

We are a medical device company that develops, manufactures and markets innovative, proprietary products for the treatment of voiding dysfunctions. Affecting urinary or fecal control, voiding dysfunctions debilitate millions of adults worldwide and cost billions of healthcare dollars. Since many of these dysfunctions are highly correlated with age, the aging population will demand increasingly better, and less invasive, solutions for these conditions.

We have developed, and are developing, products primarily for the treatment of urinary and fecal incontinence. Our products offer physicians and patients minimally invasive treatment options. All products we currently market are CE marked for European Union clearance (similar to Food and Drug administration (FDA) clearance in the U.S.). Our Macroplastique and other implantable tissue bulking products have not yet been cleared for marketing in the United States.

Macroplastique® Implants, a proprietary, implantable soft tissue bulking product is used for the treatment of both male and female urinary incontinence. When Macroplastique is injected into tissue around the urethra, it stabilizes and bulks tissues close to the urethra, thereby providing the surrounding tissue with increased capability to control the release of urine. Macroplastique is also used to treat vesicoureteral reflux, predominately a pediatric condition in which urine flows backward from the bladder to the kidney.

Macroplastique has been sold, since 1991 in over 40 countries outside of the U.S., for urological indications. Our other proprietary, implantable soft tissue bulking agents that we sell outside the United States include PTQ Implants for fecal incontinence, VOX Implants for vocal cord rehabilitation and Bioplastique® Implants for dermal augmentation.

I-Stop Mid-Urethral Sling is a biocompatible, polypropylene, tension-free sling for the treatment of female urinary incontinence. We are the exclusive distributor of this product in the United Kingdom and in the United States. In August 2005 this product received premarket clearance for sale within the United States.

Table of Contents

The Urgent® PC neuromodulation system is a minimally invasive neuromodulation device designed for office-based treatment of overactive bladder symptoms of urge incontinence, urinary urgency and urinary frequency. Using percutaneous tibial nerve stimulation, the product delivers an electrical pulse that travels to the sacral nerve plexus, a control center for bladder function. In April 2005, we acquired the exclusive rights to manufacture and distribute this product in the U.S., Canada and all countries recognizing the CE mark. We received regulatory approvals for sale of this product in the United States and Canada in October 2005, and in Europe in November 2005. Subsequently, we launched the product for sale in those markets.

Our goal is to develop and commercialize a portfolio of minimally invasive products for the treatment of voiding dysfunctions. We believe that, with a suite of innovative products, we can increasingly garner the attention of key physicians and distributors and enhance market acceptance of our products. The key elements of our strategy are to:

Pursue regulatory approval in the U.S. for our Macroplastique;

Expand our U.S. marketing and sales organization, using a combination of direct and independent reps;

Conduct multi-center, prospective clinical trials for the Urgent PC;

Expand distribution of our products outside of the U.S.; and

Acquire or license complimentary products if appropriate opportunities arise.

We concluded a multi-center human clinical trial using Macroplastique Implants in a minimally invasive, office-based procedure for treating adult female stress urinary incontinence resulting from intrinsic sphincter deficiency, a weakening of the muscles that control the flow of urine from the bladder. In December 2004, the FDA accepted for filing our pre-market approval submission with respect to Macroplastique for the treatment of adult female stress urinary incontinence. This submission is under review by the FDA and we continue to expect, as we indicated in July 2005, the possible approval by the FDA in late 2007. We will incur substantial expenses in connection with these regulatory activities. Even if we obtain regulatory approval, it may be only for limited uses with specific classes of patients, which may limit the market for our product.

In the United States, we recently staffed our sales organization, consisting of a direct field sales management team and independent sales representatives, and a marketing organization to market our products directly to our customers. We anticipate further increasing, as needed, our sales and marketing organization in the United States to support our sales growth. Outside of the United States, we sell our products primarily through a direct sales organization in the United Kingdom and through distributors in other markets.

Voiding Dysfunctions

Voiding dysfunctions affect urinary or fecal control and can result in unwanted leakage (urinary or fecal incontinence) or uncontrolled sensations (overactive bladder symptoms). We believe we are uniquely positioned to offer minimally invasive products to treat each of these voiding dysfunctions.

The Problem of Urinary Incontinence

Urinary incontinence, the uncontrolled leakage of urine, is a problem suffered by millions of people worldwide in varying degrees of severity. Because of the social stigma associated with this condition, it is often underreported. It can result in a substantial decrease in a person's quality of life, and is often the main reason a family moves an elderly person to nursing home care. The Agency for Health Care Policy and Research (AHCPR), a division of the Public Health Service, U.S. Department of Health and Human Services, estimates that urinary incontinence affects about 13 million people in the United States, of which 85% (11 million) are women. The same agency estimates the total cost of treating all types of incontinence (management and curative approaches) in the United States to be \$15 billion. Researchers at the University of California, Los Angeles determined a 38% prevalence rate of urinary incontinence among the 23 million adult women surveyed by the National Center for Health Statistics. We expect the incidence of urinary incontinence will rise as the percentage of elderly population grows.

Table of Contents

Causes of Urinary Incontinence

The mechanisms of urinary continence are complicated and involve the interaction among several anatomical structures. In females, urinary continence is controlled by the sphincter muscle and pelvic floor support structures that maintain proper urethral position. The sphincter muscle surrounds the urethra and provides constrictive pressure to prevent urine from flowing out of the bladder. Urination occurs when the sphincter relaxes as the bladder contracts, allowing urine to flow through the urethra. The urinary sphincter and pelvic floor support are also responsible for maintaining continence during periods of physical stress. Incontinence may result when any part of the urinary tract fails to function as intended. Incontinence may be caused by damage during childbirth, pelvic trauma, spinal cord injuries, neurological diseases (e.g., multiple sclerosis and poliomyelitis), birth defects (e.g., spina bifida) and degenerative changes associated with aging.

For men, urinary incontinence is most often associated with prostate conditions or nerve problems, such as complications arising from diabetes, stroke or Parkinson's disease. Enlargement of the prostate gland (the gland surrounding the male urethra just below the bladder) may impact urinary control. Approximately 400,000 prostate surgeries are performed each year in the United States for prostate enlargement or for prostate cancer. Up to 20% of men undergoing such surgery develop incontinence following the procedure.

Types of Urinary Incontinence

There are four types of urinary incontinence:

Stress Urinary Incontinence - Stress urinary incontinence, or SUI, refers to the involuntary loss of urine due to an increase in intra-abdominal pressure from ordinary physical activities, such as coughing, sneezing, laughing, straining or lifting. For the majority of women with SUI (9 million of the 11 million in the U.S.), their incontinence is caused by urethral hypermobility. Urethral hypermobility—abnormal movement of the bladder neck and urethra—occurs when the anatomic supports for the bladder neck and urethra have weakened. This anatomical change is often the result of childbirth. Stress urinary incontinence can also be caused by intrinsic sphincter deficiency, or the inability of the sphincter muscle to function properly. Intrinsic sphincter deficiency can be due to congenital sphincter weakness or can result from deterioration of the urethral muscular wall due to changes of aging or damage following trauma, spinal cord lesion or radiation therapy. The National Association for Continence (NAFC) estimates up to 15% of female stress urinary incontinence is a result of intrinsic sphincter deficiency. For many women, their SUI is a combination of urethral hypermobility and ISD.

Urge Incontinence - Urge incontinence refers to the involuntary loss of urine associated with an abrupt, strong desire to urinate. Urge incontinence often occurs when neurological problems cause the bladder to contract and empty with little or no warning.

Overflow Incontinence - Overflow incontinence is associated with an over-distention of the bladder. This can be the result of an under-active bladder or an obstruction in the bladder or urethra.

Mixed Incontinence - Mixed incontinence is the combination of both urge and stress incontinence (and, in some cases, overflow). Clinicians estimate that 30% of women suffering from stress urinary incontinence also exhibit symptoms of urge incontinence. Since prostate enlargement often obstructs the urethra, older men often have urge incontinence coupled with overflow incontinence.

Management and Curative Treatment of Urinary Incontinence

There are two general approaches to dealing with urinary incontinence. One approach is to manage symptoms with products such as pads or diapers. The other approach is to undergo curative treatments in an attempt to restore continence, such as injection of urethral tissue bulking agents or by invasive surgeries. We believe the treatment of urinary incontinence should start first with the least invasive therapy and then move to more invasive therapies only when needed.

Management of Urinary Incontinence

Absorbent Products. Absorbent products are the most common form of management for urinary incontinence because men and women can use them without consulting a physician. The cost of adult diapers and pads can be substantial

and create a continuous financial burden for patients. Additionally, this management technique may require frequent changing of diapers and pads to control patient embarrassment due to odor or soiling.

Table of Contents

Behavior Modification. Techniques used in behavior modification include bladder training, scheduled voiding and pelvic floor muscle exercises known as Kegels. Some of the tools used in conjunction with these training regimes are vaginal cones or weights, biofeedback devices and pelvic floor stimulation. Because these techniques rely on active, frequent participation of the individual, these techniques are seldom effective.

Occlusion and Compression Devices. Penile clamps, pessaries and urethral occlusion devices are typically reserved for temporary use. Complications such as tissue erosion, urinary tract infections, edema, pain and obstruction are associated with extended or improper use.

Urinary Catheters and Collection Devices. The type and severity of incontinence and an individual's physical and mental condition determine the choice of catheter. Catheters may be inserted as needed for bladder drainage and may be a closed, indwelling system or an external collection device.

Drug Therapy. Drug treatment is used to manage multiple types of urinary incontinence. Therapeutic drug activity is matched to the individual's urinary dysfunction, e.g., activity targeted to contract muscle tissue of the bladder or bladder neck or to improve the quality of the bladder neck and urethra mucosal lining. Drugs are most often used to treat symptoms of overactive bladder but drugs seldom cure stress urinary incontinence. Common side effects of drugs include dry mouth, constipation and headache. Other potential side effects include urinary retention, nausea, dizziness, blurred vision and the possibility of unwanted interactions with other drugs.

Curative Treatment of Urinary Incontinence

Injectable Urethral Tissue Bulking Agents. Urethral tissue bulking agents are inserted with a needle into the area around the urethra, augmenting the surrounding tissue for increased capacity to control the release of urine. Hence, these materials are often called bulking agents or injectables. Urethral bulking agents may be either synthetic or biologically derived and are an attractive alternative to surgery because they are considerably less invasive. Active women benefit from the use of urethral bulking agents since they will often return to normal activities in a matter of days instead of weeks of recovery following invasive surgical procedures. Bulking agents also represent a desirable treatment option for the elderly or infirm who may not otherwise be able to withstand the trauma and morbidity resulting from a fully invasive surgical procedure. Additionally, the use of a urethral bulking agent does not preclude the use of more invasive treatments if required.

Biologically derived bulking agents include a patient's own fat cells, polysaccharides (not commercially available in the United States) or bovine collagen. Fat injections involve complex, invasive harvesting of the patient's own fat cells and re-injecting them into the bladder neck. Collagen injections require pre-treatment allergy skin tests and, since the body absorbs collagen over time, the patient may require subsequent re-injections.

Synthetic bulking agents include solid silicone elastomers, pyrolytic carbon-coated beads, and DMSO and polyvinyl alcohol.

Surgery. In women, stress urinary incontinence can be surgically corrected through a procedure in which the physician elevates and stabilizes the urethra and bladder neck, often with a sling to support these structures. Market adoption of sling procedures is demonstrated by over 10% annual growth during the last five years. An estimated 180,000 sling procedures were performed in the U.S. during 2005, with almost half of these procedures using a tension-free sling product, usually implanted in an outpatient setting. Numerous publications cite sling procedure efficacy greater than 85%.

In men, the surgical options for treating urinary incontinence are a male sling or an implanted artificial urinary sphincter, a patient-controlled device that keeps the urethra closed until the patient is ready to urinate. Surgery to place the artificial sphincter requires general or spinal anesthesia.

Uroplasty Solutions for Urinary Incontinence

We believe that we are uniquely positioned with differentiable, minimally invasive products to address both causes of SUI—an injectable bulking agent to treat ISD and a tension-free type sling to treat urethral hypermobility.

Macroplastique® Implants

Macroplastique® is an injectable soft-tissue bulking agent used to treat stress urinary incontinence, the most common form of urinary incontinence in women. It is designed to restore the patient's urinary continence immediately following treatment.

Table of Contents

Additionally, men who experience incontinence as a result of prostate surgery are also candidates for Macroplastique treatment.

Macroplastique is a soft-textured, permanent implant placed endoscopically around the urethra distal to the bladder neck. It is a proprietary composition of heat vulcanized, solid, soft, irregularly shaped polydimethylsiloxane (solid silicone) implants suspended in a biocompatible carrier gel. We believe our compound is better than other commercially available bulking agents because it does not degrade, is not absorbed into surrounding tissues and does not migrate from the implant site due to its unique composition, shape and size. This reduces the need for follow-up treatments. Additionally, there is no need for special storage, cumbersome preparation or mixing for use or for patient allergy testing.

We currently market Macroplastique outside the U.S. Macroplastique is an outpatient, minimally invasive treatment that offers lower surgical risk with shorter recovery time, and a less expensive alternative when compared to invasive procedures. Its safety and efficacy are evidenced by over 14 years of successful use outside the United States with over 50,000 patients treated. We concluded a multi-center human clinical trial using Macroplastique Implants in a minimally invasive, office-based procedure for treating adult female stress urinary incontinence resulting from intrinsic sphincter deficiency, a weakening of the muscles that control the flow of urine from the bladder. In December 2004, the FDA accepted for filing our pre-market approval submission with respect to Macroplastique for the treatment of adult female stress urinary incontinence. This submission is under review by the FDA and we continue to expect, as we indicated in July 2005, the possible approval by the FDA in late 2007. We will incur substantial expenses in connection with these regulatory activities. Even if we obtain regulatory approval, it may be only for limited uses with specific classes of patients, which may limit the market for our product.

Although Macroplastique is traditionally implanted with the aid of an endoscope, we also market outside the United States a patented, non-endoscopic product placement kit, or delivery kit, called the Macroplastique Implantation System, or MIS, for office-based treatment of female stress urinary incontinence. Our MIS enables easy and consistent product placement without the use of an endoscope. Following FDA approval of Macroplastique, we intend to seek regulatory approval for the MIS.

I-Stop Sling

We are the exclusive distributor in the United States and the United Kingdom of the I-Stop tape, a biocompatible, tension-free, mid-urethral sling manufactured by CL Medical SAS of Lyon, France. The I-Stop tape has received FDA premarket approval and is CE marked for the treatment of female urinary incontinence due to urethral hypermobility. If the urethra is no longer appropriately supported by the surrounding tissues and ligaments, the urethra may move too easily and may no longer properly close. A sling provides a hammock-type support for the urethra to prevent its downward movement, and associated leakage of urine, during periods of increased abdominal pressure.

I-Stop, the only synthetic, mid-urethral sling made of monofilament knitted polypropylene, has closed loop edges, which we believe make it non-damaging to surrounding tissue without the need for a delivery sheath. We also believe that the I-Stop design provides greater strength and controlled flexibility, and improved resistance to fragmentation, stretching and deformity during the outpatient implant procedure, than competitive sling devices. For patients, we believe that our tape design results in less irritation and fewer overall complications. We believe our product is competitively priced and we offer components to address the retropubic and transobturator surgical approaches.

In May 2005, we entered into a one-year exclusive agreement with CL Medical to distribute the I-Stop in the United Kingdom. The agreement is renewable for up to 2 years, subject to certain performance requirements of us. We are required to purchase a minimum of \$266,000 of units in the 12-month period following January 1, 2006, subject to periodic adjustment based on the value of the euro. The purchase price is payable in euros. If we fail to reach our minimum purchase requirement, CL Medical has the right to terminate our exclusive distribution rights in the United Kingdom.

In February 2006 we entered into a six-year exclusive agreement with CL Medical to distribute the I-Stop in the U.S. The agreement is renewable for successive five-year terms, subject to certain performance requirements of us. We are required to purchase a minimum of \$363,000 of units in the first 12-month period following January 1, 2006, increasing to approximately \$2.6 million of units in the fifth year, for an aggregate commitment of approximately \$6.5 million of units over the five-year period, subject to periodic adjustment based on the value of the euro. The

purchase price is payable in euros. If we fail to reach our minimum purchase requirement in any 12-month period, CL Medical has the right to terminate our exclusive distribution rights in the United States. CL Medical has agreed to provide us, without additional charge, with any improvements or modifications it makes to the I-Stop sling and has granted us a right of first refusal for exclusive distribution rights in the United States to any new medical devices or procedures it develops. We have agreed that during,

Table of Contents

and for one year after, the term of this agreement, we will not manufacture our own, or market any other party's tension-free vaginal tape product for the treatment of female stress urinary incontinence. If for some reason CL Medical is prohibited from exporting the I-Stop into the United States, CL Medical is required to supply us with the components necessary to manufacture, package and label the I-Stop for the United States market.

The Problem of Overactive Bladder

Overactive bladder (OAB) is a prevalent and challenging urologic problem affecting 16% of the adult population. An estimated 34 million Americans suffer from overactive bladder, although fewer than 40% seek medical help. A survey of individuals with OAB estimated the total U.S. economic cost of OAB (direct and indirect costs) to be \$12 billion. For individuals with overactive bladder, the nervous system control for bladder filling and urinary voiding is incompetent. Signals to indicate a full bladder are sent early and frequently, triggers to allow the bladder to relax for filling are ineffective and nervous control of the urethral sphincter, to keep the bladder closed until an appropriate time, is inadequate. An individual with OAB may exhibit one or all of the symptoms that characterize overactive bladder: urinary urgency, urinary frequency and urge incontinence. Urgency is the strong, compelling need to urinate. Frequency is a repetitive need to void. Normal urinary voiding is eight times per day. Individuals with an overactive bladder may seek to void over 20 times per day and at least two times during the night, thereby causing significant sleep pattern disturbances. Urge incontinence is an immediate, compelling need to urinate that typically results in an accident before the individual can reach the restroom.

Treatment of Overactive Bladder Symptoms

Drug Therapy. The most common treatment for OAB is drug therapy using an anticholinergic agent. However, for some individuals, the drugs are ineffective or the side effects so bothersome that the patient discontinues the medications. Common side effects include dry mouth, constipation and headache.

Biofeedback and Behavioral Modification. Bladder training and scheduled voiding techniques, often accompanied by the use of voiding diaries, are a non-invasive approach to managing OAB. Because these techniques rely on the diligence and compliance of the individual, these techniques are seldom effective. In addition, for OAB symptoms, these techniques may not affect the underlying cause of the condition.

Neuromodulation. Normal urinary control is dependent upon properly functioning neural pathways and coordination among the central and peripheral nervous systems, the nerve pathways, bladder and sphincter. Unwanted, uncoordinated or disrupted signals along these pathways can lead to overactive bladder symptoms. Therapy using neuromodulation incorporates electrical stimulation to target specific neural tissue and jam the pathways transmitting unwanted signals. To alter bladder function, the stimulation must be delivered to the sacral nerve plexus, the neural tissue affecting bladder activity. Neuromodulation for OAB is presently conducted through sacral nerve stimulation or percutaneous tibial nerve stimulation.

The sacral nerve stimulator uses a small device, a neurostimulator, to send mild electrical pulses to the sacral nerve. The sacral nerve is located in the lower back, just above the tailbone. The surgically implanted neurostimulator contains a battery and electronics to create the electrical pulses and is connected to a neurostimulation lead (an insulated wire) containing electrodes through which stimulation is delivered to the nerve. The device is most frequently placed under the skin of the buttock, with the lead under the skin near the spine.

Alternatively, percutaneous tibial nerve stimulation (PTNS) delivers stimulation to the sacral nerve plexus by temporarily applying electrical pulses to the tibial nerve. The tibial nerve is an easily accessed nerve in the lower leg. Neuromodulation using PTNS has a similar therapeutic effect as the implantable sacral nerve stimulator, but requires no surgery. PTNS is minimally invasive, has a low risk of complication and is typically performed in a physician's office.

Uroplasty Solutions for Overactive Bladder

Urgent® PC Neuromodulation System

In April 2005, we entered into an exclusive manufacturing and distribution agreement with CystoMedix, Inc., an Andover, Minnesota medical device company, the exclusive rights to manufacture and market the Urgent® PC Neuromodulation System for the U.S., Canada and all countries recognizing the CE mark. The Urgent PC is a minimally invasive nerve stimulation device designed for office-based treatment of urge incontinence, urinary urgency and urinary frequency

Table of Contents

symptoms of an overactive bladder. Using percutaneous tibial nerve stimulation near the ankle, the product delivers an electrical pulse that travels to the sacral nerve plexus, a control center for bladder function.

We believe that the Urgent PC system is the only non-surgical neuromodulation device in the U.S. market for treatment of overactive bladder symptoms. Components of the Urgent PC system include a hair-width needle electrode, a lead set and an external, handheld, battery-powered stimulator. For each 30-minute office-based therapeutic session, the physician temporarily inserts the needle electrode in the patient's lower leg and connects the electrode to the stimulator. Typically, a patient undergoes 12 treatment sessions at one-week intervals, with follow up treatments as required to maintain symptom reduction.

Under our agreement with CystoMedix, we are responsible for regulatory applications and compliance within all markets outlined in the agreement. Although the Urgent PC as marketed by CystoMedix was CE marked and 510(k) cleared, following minor revisions to the product, we secured 510(k) clearance for the device in October 2005 and CE mark in November 2005. Subsequently we launched the product for sale. We have since then developed a second generation Urgent PC, and in June 2006, received for it the 510(k) clearance, CE Mark and regulatory approval to sell in Canada.

In connection with the agreement with CystoMedix, we purchased 75% of CystoMedix's inventory of component parts and subassemblies for \$25,000. We paid an initial royalty payment of \$225,000 in May 2005 and paid an additional aggregate of \$250,000 in royalties in monthly installments through May 2006. During the agreement's term, we will pay CystoMedix further royalties of 7% of our net product revenues from the sale of licensed products, offset by payments made against the above \$250,000 royalty amount. We agreed to sell licensed products we manufacture back to CystoMedix, on a non-exclusive basis, on terms and for such price as we may mutually negotiate for CystoMedix's own sales outside of the territories exclusively licensed to us.

Our five-year agreement with CystoMedix provides no renewal provision. Between January 2006 and June 2008, we may elect to purchase all of CystoMedix's assets. The option price is \$3,485,000, reduced by up to \$50,000 of liabilities assumed by us. After April 2007 the option price will increase at a rate of 10% per year. The option price is payable in shares of our common stock valued at the average of the closing bid price of our shares for the 20 trading days prior to our exercise of the option. If we exercise our option, we also assume up to \$1.4 million of bridge loan advances made to CystoMedix by its Chairman. We would repay up to \$1.1 million of the bridge loan advances at closing and would issue our common stock for the balance of the bridge loan based on the above option price. We also have certain rights of first refusal to acquire CystoMedix's assets in the event CystoMedix receives a third party offer in advance of any exercise of our option.

The Problem of Fecal Incontinence

Fecal incontinence, prevalent in 2-6% of the adult population, with women suffering up to four times more often than men, is an extremely disabling and embarrassing condition. Approximately 25% of women with stress urinary incontinence are also diagnosed with fecal incontinence.

Fecal continence relies on an intact and functioning anal sphincter. The internal anal sphincter (IAS) provides most of the resting anal pressure and is the main muscle responsible for the prevention of anal leakage. Degeneration or disruption of the IAS characteristically leads to fecal incontinence or soiling. Degeneration can result from childbirth, surgical trauma or accident.

Treatment of Fecal Incontinence

The internal sphincter cannot be surgically repaired, as it is extremely thin (approximately 2-3 mm) and, as a circular muscle, is under tension. Antidiarrheal drugs and diet modification help some patients, but this is not a satisfactory, long-term solution for most patients.

Uroplasty Solutions for Fecal Incontinence

We have, and are developing additional, minimally invasive products to address fecal incontinence. Our PTQ Implants offer a minimally invasive treatment for patients with fecal incontinence. They are soft-textured, permanent implants. For treatment of fecal incontinence, PTQ Implants are implanted circumferentially into the submucosa of the anal canal. Injection creates a bulking and supportive effect similar to that of Macroplastique injection for the treatment of stress urinary incontinence. The product is CE marked and currently sold outside the U.S. in various international markets. We also secured CE mark for the application of percutaneous tibial nerve stimulation for the

treatment of fecal incontinence. Our Urgent PC is sold for the treatment of fecal incontinence in countries recognizing the CE mark.

Table of Contents

Other Uroplasty Products

In addition to urological applications, we market our proprietary tissue bulking material outside the United States for reconstructive and cosmetic plastic surgery under the trade name Bioplastique® Implants and for otolaryngology vocal cord rehabilitation applications under the trade name VOX® Implants.

In The Netherlands and United Kingdom only, we distribute certain wound care products in accordance with a distributor agreement. Under the terms of the distributor agreement, we are not obligated to purchase any minimum level of wound care products.

Marketing, Distribution and Sales

We currently sell two products in the United States – the I-Stop Sling and the Urgent PC Neuromodulation System. We received regulatory approvals for sale of our Urgent® PC Neuromodulation System, the only minimally invasive nerve stimulation device designed for office-based treatment of overactive bladder symptoms of urge incontinence, urinary urgency and urinary frequency, in the United States and Canada in October 2005 and in Europe in November 2005. Subsequently, we launched this product for sale in those markets.

Our U.S. sales organization consists of a direct field-based sales management group and a nationwide network of independent sales representatives. We anticipate continuing to increase our sales and marketing organization, as needed, to support the sales growth.

Outside of the United States, in addition to our Urgent® PC Neuromodulation system, we market and sell Macroplastique and related ancillary products, PTQ Implants, VOX Implants and Bioplastique Implants, and, in the United Kingdom we also sell the I-Stop sling. We sell our products primarily through a direct sales organization in the United Kingdom. In all other markets we sell our products primarily through distributors. International sales managers in The Netherlands manage and train a network of distributors in approximately 40 countries, including Canada, Australia, countries within Europe and Latin America. Each of our distributors has a territory-specific distribution agreement, including requirements indicating they may not sell injectable products that compete directly with Macroplastique. Collectively, our distributors accounted for approximately 65% and 70% of total net sales for fiscal 2006 and 2005, respectively.

We use clinical studies and scientific community awareness programs to demonstrate the safety and efficacy of our products. This data is important to obtain regulatory approval and to support our sales staff and distributors in securing product reimbursement in their territories. Publications of clinical data in peer-reviewed journals add to the scientific community awareness of our products, including therapeutic applications, treatment techniques and expected outcomes. Our clinical research department provides a range of activities designed to support surgeons in their clinical evaluation study design, abstract preparation, manuscript creation and/or review and submission. This team works closely with our sales and marketing and regulatory departments in the area of technical support, submissions, literature review, and analysis and synopsis of technical presentations and publications.

Researchers have designed clinical trials to provide outcome evidence on products developed by us. These include randomized controlled trials on our PTQ Implants, Macroplastique Sling Support Kit (MIS-SK) and a multi-center prospective study on the efficacy of the Urgent PC. Evidence-based clinical research broadens the surgeons acceptance by providing detailed information related to product safety and efficacy when applied to patient selection and comparative surgical and non-surgical treatment regimens. Only by recognition of the complexity of our product, indications, analysis of the contributing variables and presentation and publication of the clinical outcomes, will we provide the physicians, patients and reimbursement systems with the evidence they require to make informed decisions.

Manufacturing and Suppliers

We manufacture our tissue bulking products at our own facilities. We manufacture components in the United States and finished products in The Netherlands. Our facilities utilize dedicated heating, ventilation and high efficiency particulate air (HEPA) filtration systems to provide a controlled working environment. Trained technicians perform all critical manufacturing processes in a cleanroom environment according to validated written procedures. An outside vendor sterilizes our products using validated methods and returns the products to us for final inspection and testing.

Table of Contents

Our manufacturing facilities and systems are periodically audited to ensure compliance with ISO 13485 (medical device quality management systems), and applicable European and Canadian medical device requirements. Our facilities and systems were last audited by AMTAC Certification Services in January 2005. No major deficiencies were noted, and we were found to be in compliance with all standards and requirements audited.

Our facilities also need to be compliant with U.S. federal Quality System Regulations (QSR). While we believe we are compliant with QSR, our facilities have not yet been audited by the FDA for such compliance, and there can be no guarantee that we will pass the FDA compliance audit. We are also subject to additional state, local, and U.S. federal government regulations applicable to the manufacture of our products.

CL Medical designs and manufactures the I-Stop sling. Pursuant to our distribution agreements with CL Medical, we are the exclusive distributor of the I-Stop sling in the United States and the United Kingdom. Among other things, we are required to purchase a minimum number of I-Stop product sets from CL Medical.

Under our manufacturing and distribution agreement with CystoMedix, Inc., we are responsible for the manufacture of the Urgent PC device. We currently subcontract the manufacture of major subassemblies for the product.

We purchase medical grade materials for use in our finished products from several single source suppliers. Our quality department has qualified these suppliers. Although we believe our supply sources could be replaced if necessary without due disruption, it is possible that the process of qualifying suppliers for certain raw materials could cause an interruption in our ability to manufacture our products, which could have a negative impact on sales.

Competition

The market for voiding dysfunction products is intensely competitive. Competitors offer management and curative treatments, including commercialized tissue bulking agents, urethral sling products and neurostimulation devices. Indirect and future competitors include drug companies and firms developing new or improved treatment methods. We believe the principal decision factors among treatment methods include physician and patient acceptance of the treatment method and cost, availability of third-party reimbursement, marketing and sales coverage and the existence of meaningful patent protection. In addition to addressing the decision factors, our ability to effectively compete in this market will also depend on the consistency of our product quality as well as delivery and product pricing. Other factors affecting our success include our product development and innovation capabilities, clinical study results, ability to obtain required regulatory approvals, ability to protect our proprietary technology, manufacturing and marketing capabilities and ability to attract and retain skilled employees.

Soft-tissue injectable bulking agents competing directly with Macroplastique®, both outside and in the U.S. include Contigen® and Tegress®, both FDA-approved bulking agents manufactured by C.R. Bard, Inc.; Zuidex® and Deflux® (Deflex FDA approved for VUR use only) manufactured by Q-Med AB; Durasphere® (FDA-approved for female SUI) manufactured by Carbon Medical Technologies; and Coaptite® manufactured by BioForm, Inc. for Boston Scientific. In contrast to the competitors products currently approved for sale, Macroplastique, marketed outside the United States since 1991, is a synthetic material that will not degrade, resorb or migrate, has no special preparation or storage requirements and does not require the patient to have a skin test prior to the procedure. The silicone-elastomer material has been studied for over 50 years in medical use for such urological applications as artificial urinary sphincters, penile implants, stents and catheters. Our patented Macroplastique® Implantation System offers a unique, non-endoscopic, minimally invasive out-patient procedure that can be performed in the physician's office.

Sling procedures have become the preferred method for treating urethral hypermobility. The tension-free sling market is dominated by Gynecare's TVT Tension-free Support device. Other companies competing in this market include American Medical Systems, C.R. Bard, Boston Scientific and Mentor Corporation. We believe our I-Stop sling offers benefits of multiple surgical approaches for the physician and a design to resist stretching, deformity and fragmentation.

The Urgent®PC neurostimulation device is an alternative to the more invasive Medtronic InterStim® device. The Medtronic unit, which stimulates the sacral nerve, requires surgical implantation in the upper buttocks or abdomen. In contrast, the Urgent PC device allows minimally invasive stimulation of the sacral nerve plexus in an office-based setting without surgical intervention. Neotonus markets a non-surgical device to deliver extracorporeal magnetic neuromodulation. In addition, Boston Scientific's Bion® Microstimulator, a device implanted with a needle-like

instrument to stimulate the pudendal nerve, is CE mark approved for the treatment of urinary urge incontinence and is undergoing clinical studies in the U.S.

Table of Contents

Many medications treat symptoms of overactive bladder, some by preventing unwanted bladder contractions, others by tightening the bladder or urethra muscles and some by relaxing bladder muscles. Sometimes, these drugs have unwanted side effects such as dry mouth, vision problems or constipation. Among these medications are Detrol® (Pfizer Inc.), Ditropan® (Alza Corporation) and Flomax® (Abbott Laboratories).

Many of our competitors and potential competitors have significantly greater financial, manufacturing, marketing and distribution resources and experience than we have. In addition, many of our competitors offer broader product lines within the urology market, which may give these competitors the ability to negotiate exclusive, long-term supply contracts and to offer comprehensive pricing for their products. It is possible other large health care and consumer products companies may enter this industry in the future. Furthermore, smaller companies, academic institutions, governmental agencies and other public and private research organizations will continue to conduct research, seek patent protection and establish arrangements for commercializing products. These products may compete directly with any products that we may offer in the future.

Government Regulation

The design, testing, manufacturing, promotion, marketing and distribution of our products in the United States, Europe and other parts of the world are subject to regulation by numerous governmental authorities, including the U.S. Food and Drug Administration, or FDA, the European Union and other analogous agencies.

United States

Our products are regulated in the United States as medical devices by the FDA under the Food, Drug and Cosmetic Act. Noncompliance with applicable requirements can result in, among other things:

- fines, injunctions, and civil penalties;

- recall or seizure of products;

- operating restrictions, or total or partial suspension of production;

- denial of requests for 510(k) clearance or pre-market approval of new products;

- withdrawal of existing approvals; and

- criminal prosecution.

Depending on the degree of risk posed by the medical device and the extent of controls needed to ensure safety and effectiveness, there are two pathways for FDA marketing clearance of medical devices. For devices deemed by FDA to pose relatively less risk (Class I or Class II devices), manufacturers, in most instances, may submit a pre-market notification (510(k) clearance) requesting permission for commercial distribution. Devices deemed by the FDA to pose the greatest risk (Class III devices), such as life-sustaining, life-supporting or implantable devices, or a device deemed not to be substantially equivalent to a previously cleared 510(k) device, require the submission of a pre-market approval (PMA) application. The FDA can also impose restrictions on the sale, distribution or use of devices at the time of their clearance or approval, or subsequent to marketing.

510(k) Clearance. To obtain 510(k) clearance, the pre-market notification must demonstrate that the proposed device is substantially equivalent in intended use and in safety and effectiveness to a previously 510(k) cleared device or a device that was commercially distributed before May 28, 1976 and for which FDA has not yet called for submission of a pre-market approval application. The FDA attempts to respond to a 510(k) pre-market notification within 90 days of submission of the notification, but the response may be a request for additional information, sometimes including clinical data. As a practical matter, 510(k) clearance can take significantly longer than 90 days, including up to one year or more.

After a device receives 510(k) clearance for a specific intended use, modifications or enhancements that could significantly affect the safety or effectiveness of the device or that would constitute a major change to the intended use of the device will require a new 510(k) pre-market notification submission or, depending upon the changes, could require pre-market approval. The FDA requires each manufacturer to make this determination initially, but the FDA

can review any such decision. If the FDA disagrees with a manufacturer's determination that a new clearance or approval is not required for a particular modification, the FDA can require the manufacturer to cease marketing or recall the modified device until 510(k) clearance

Table of Contents

or pre-market approval is obtained. Also, in these circumstances, a company may be subject to significant regulatory fines or penalties.

Pre-market Approval. A pre-market approval application must be submitted if the device cannot be cleared through the 510(k) process. The pre-market approval process is much more demanding than the 510(k) notification process. A pre-market approval applicant must provide extensive preclinical and clinical trial data as well as information about the device and its components regarding, among other things, device design, manufacturing and labeling. As part of the pre-market approval process, applicants must file an Investigational Device Exemption, or IDE, application prior to commencing human clinical trials. If the IDE application is approved by the FDA, human clinical trials may begin at a specific number of investigational sites with a maximum number of patients. The results of clinical testing may not be sufficient to obtain approval of the product.

After the FDA determines that a pre-market approval application is complete, the FDA accepts the application and begins an in-depth review of the submitted information. The FDA, by statute and regulation, has 180 days to review an accepted pre-market approval application, although the review generally occurs over a significantly longer period of time, and can take up to several years. During this review period, the FDA may request additional information or clarification of information already provided. Also during this review period, an advisory panel of experts from outside the FDA may be convened to review and evaluate the application and provide recommendations to the FDA as to the approvability of the device. In addition, the FDA will conduct a pre-approval inspection of the manufacturing facility to ensure compliance with the Quality System Regulations. New pre-market approval applications or supplemental pre-market approval applications are required for significant modifications to the manufacturing process, labeling, use and design of a device that is approved through the pre-market approval process. Pre-market approval supplements often require submission of the same type of information as a pre-market approval, except that the supplement is limited to information needed to support any device changes not covered by the original pre-market approval application, and may not require as extensive clinical data as the original submission or the convening of an advisory panel.

Continuing FDA Regulation. After a device is placed on the market, numerous regulatory requirements apply. These include:

- Quality System Regulations, which require manufacturers to follow design, testing, control, documentation and other quality assurance procedures during the manufacturing process;

- labeling regulations, which govern product labels and labeling, prohibit the promotion of products for unapproved or off-label uses and impose other restrictions on labeling and promotional activities;

- medical device reporting regulations, which require that manufacturers report to the FDA if their device may have caused or contributed to a death or serious injury or malfunctioned in a way that would likely cause or contribute to a death or serious injury if it were to recur;

- post-market surveillance activities monitor use of the products placed in the market place; and

- notices of correction or removal, and recall regulations.

FDA Approval Status of Our Products. The FDA has determined that urethral tissue bulking agents, such as Macroplastique, are Class III devices and require FDA clearance of a pre-market approval application. In 1999, the FDA approved our IDE application for the use of Macroplastique in a clinical study for the treatment of stress urinary incontinence. In 2000, we commenced human clinical trials at multiple sites. We concluded the 12-month patient follow up visits for this study and, in 2004 submitted a pre-market approval application. This submission is under review by the FDA and we continue to expect, as we indicated in July 2005, the possible approval by the FDA in late 2007. Even if we obtain regulatory approval, it may be only for limited uses with specific classes of patients, which may limit the market for our product.

In August 2005, the I-Stop product received premarket clearance for sale within the United States.

The Urgent PC device previously received 510(k) clearance for U.S. marketing by the FDA. However, following product revisions, we submitted our 510(k) pre-market application in August 2005. We received 510(k) clearance in October 2005 for our version of the Urgent PC device. Following development of our second generation of the Urgent PC, in May 2006 we submitted a special 510(k) pre-market application. With regards to our second generation Urgent PC, in June 2006, we received the CE mark and approval from Therapeutic Products Directorate of Health to sell in Canada.

Table of Contents

FDA Oversight of Manufacturing Operations. The Food, Drug and Cosmetics Act requires that medical devices be designed and manufactured in accordance with the FDA's current Quality System Regulations, which require, among other things, that we:

regulate our design and manufacturing processes and control them by the use of written procedures;

investigate any deficiencies in our manufacturing process or in the products we produce;

keep detailed records and maintain a corrective and preventative action plan; and

allow the FDA to inspect our manufacturing facilities on a periodic basis to monitor our compliance with Quality System Regulations.

Although our manufacturing facilities and processes have been inspected and certified in compliance with ISO 13485, applicable European medical device directives, and Canadian Medical Device Requirements, they have not been inspected by the FDA for compliance with Quality System Regulations. We will be required to have a FDA inspection prior to the pre-market approval of our Macroplastique product for sale in the U.S. We cannot assure you that our facilities and processes will be found to comply with Quality System Regulations and there is a risk that approval will, therefore, be delayed by the FDA until such compliance is achieved.

European Union and Other Regions

The European Union has adopted rules that require that medical products receive the right to affix the CE mark, which stands for Conformité Européenne. The CE mark demonstrates adherence to quality assurance standards and compliance with relevant European medical device directives. Products that bear the CE mark can be imported to, sold or distributed within, the European Union.

We received CE marking approval for Macroplastique in 1996 for the treatment of male and female stress urinary incontinence and vesicoureteral reflux; for the Urgent PC for the treatment of fecal incontinence, and overactive bladder symptoms of urinary urgency, urinary frequency and urge incontinence. In addition, we received CE marking for PTQ Implants in 2002 for the treatment of fecal incontinence; for VOX Implants in 2000 for vocal cord rehabilitation applications; and for Bioplastique Implants in 1996 for dermal augmentation applications. The I-Stop sling received CE marking approval in July 2002. Our European manufacturing facilities and processes have been inspected and certified by AMTAC Certification Services, a recognized Notified Body, testing and certification firm based in the United Kingdom.

We currently sell our products in approximately 40 foreign countries, including those within the European Union. Requirements pertaining to medical devices vary widely from country to country, ranging from no health regulations to detailed submissions such as those required by the FDA. We have obtained regulatory approval where required for us to sell our products in the country. We believe the extent and complexity of regulations for medical devices are increasing worldwide. We anticipate that this trend will continue and that the cost and time required to obtain approval to market in any given country will increase.

Third-Party Reimbursement

In both U.S. markets and markets outside the U.S., sales of our products will depend in part on the availability of reimbursement from third-party payors. Outside of the United States, government managed health care systems and private insurance control reimbursement for devices and procedures. Reimbursement systems in international markets vary significantly by country. In the European Union, reimbursement decision-making is neither regulated nor integrated at the European Union level. Each country has its own system, often closely protected by its corresponding national government. Reimbursement for Macroplastique and other tissue bulking products has been successful in multiple international markets where hospitals and physicians have been able to get budgets approved by fund-holder trusts or global hospital budgets.

In the U.S., third-party payors consist of government programs, such as Medicare, private health insurance plans, managed care organizations and other similar programs. For any product, three factors are critical to reimbursement:

coding, which ensures uniform descriptions of procedures, diagnoses and medical products;

Table of Contents

coverage, which is the payor's policy describing the clinical circumstances under which it will pay for a given treatment; and

payment amount.

Reimbursement for tension-free sling products has been previously addressed by numerous competitors. As a result coding, coverage and payment for the I-Stop Mid-Urethral Sling is already well-established.

As a relatively new therapy, nerve simulation using the Urgent PC has not been assigned a reimbursement code unique to the technology. However, a number of practitioners are using an existing reimbursement code that closely describes the procedure. In addition, Aetna and Blue Cross Blue Shield of Minnesota and Maryland have published policies providing coverage for PTNS under an existing reimbursement code. We will need to continue to work with third-party payers for coverage policies and the American Medical Association to develop definitive and uniform reimbursement for the therapy. In addition, we will need to provide customer reimbursement support as we market the product and secure medical community acceptance.

We believe, but cannot confirm, that there are appropriate codes available to describe endoscopic use of Macroplastique to treat female SUI. We expect that, upon FDA approval to market Macroplastique, we will need to foster coverage policies and payer acceptance to support the U.S. launch. There is no guarantee that Macroplastique will be reimbursed at the levels expected by us, if at all.

Patents, Trademarks and Licenses

Our success depends in part on our ability to obtain and maintain patent protection for our products, preserve our trade secrets and operate without infringing the proprietary rights of third parties. We seek to protect our technology by filing patent applications for technologies important to the development of our business following an analysis of the cost of obtaining a patent, the likely scope of protection, the relative benefits of patent protection compared to trade secret protection and other business considerations.

We hold multiple patents covering our Macroplastique materials, processes and applications. As of the date of this report, we have four issued U.S. patents and 19 granted patents in the United Kingdom, Japan, Germany, France, Spain, Italy, Portugal, The Netherlands and Canada. Our patents will expire in the U.S. at various times between 2011 and 2016 and in other countries between 2009 and 2017. There can be no assurance any of our issued patents are of sufficient scope or strength to provide meaningful protection of our products. In addition, there can be no assurance any current or future U.S. and foreign patents of ours will not be challenged, narrowed, invalidated or circumvented by competitors or others, or that our patents will provide us with any competitive advantage. Any legal proceedings to maintain, defend or enforce our patent rights could be lengthy and costly, with no guarantee of success. CystoMedix and CL Medical also have certain patent rights which they licensed to us as part of their respective manufacturing and distribution agreements. We are awaiting prosecution of the patent protection applications we filed in 2006 for the Urgent PC.

In 1992, we agreed to settle alleged patent infringement claims by Collagen Corporation (now Inamed Corporation). Under the settlement agreement, we pay Collagen a royalty of 5% of net sales in the U.S. of Macroplastique products with a minimum, through May 1, 2006, of \$50,000 per year.

Although we intend to apply for additional patents and vigorously defend issued patents, management believes our business success will depend primarily upon our development and sales and marketing skills, and the quality and economic value of our products rather than on our ability to obtain and defend patents.

We also seek to protect our trade secrets by requiring employees, consultants, and other parties to sign confidentiality agreements and noncompetition agreements, and by limiting access by outside parties to confidential information. There can be no assurance, however, these measures will prevent the unauthorized disclosure or use of this information or that others will not be able to independently develop this information.

We have registered Macroplastique®, Uroplasty® and Bioplastique® as trademarks with the U.S. Patent and Trademark Office. Our non-registered trademarks include VOX and PTQ, for which trademark registration applications are pending in the U.S. Patent and Trademark Office and in European countries. In addition, Macroplastique is registered in numerous European countries. CystoMedix has U.S. registration of the Urgent®PC trademark and has licensed the mark to

Table of Contents

us as part of our exclusive manufacturing and distribution agreement. In addition, CL Medical has licensed its non-registered trademark for the I-Stop sling to us as part of our agreement with it.

We have a royalty agreement with three individuals, two of whom are former officers and directors. Under this royalty agreement, we pay aggregate royalties of three to five percent of net sales of Macroplastique and Bioplastique, subject to a monthly minimum of \$4,500. The royalties payable under this agreement will continue until the patent referenced in the agreement expires in 2010.

In October 1998, we received an absolute assignment from a British surgeon of a patent relating to the Macroplastique Implantation System in return for a royalty of £10 for each unit sold during the life of the patent. We began commercialization of the product outside the U.S. in March 2000.

Research and Development

We have a research and development program to develop new incontinence products. We are also continually evaluating product potential improvements, and new methods and devices for the implantation of and new applications for Macroplastique. Research and development expenses also include the costs of clinical studies and regulatory compliance. Our expenditures for research and development totaled \$3.3 and \$2.3 million for fiscal 2006 and 2005, respectively. None of these costs were borne directly by customers.

Product Liability

The medical device industry is subject to substantial litigation. As a manufacturer of a long-term implantable device, we face an inherent risk of liability for claims alleging adverse effects to the patient. We currently carry \$2 million of worldwide product liability insurance, plus another policy specific to the United Kingdom only. There can be no assurance, however, our existing insurance coverage limits are adequate to protect us from any liabilities we might incur. There can be no assurance that liability claims will not exceed coverage limits. Product liability insurance is expensive and in the future may not be available to us on acceptable terms, if at all. Furthermore, we do not expect to be able to obtain insurance covering our costs and losses as a result of any product recall. A successful claim in excess of our insurance coverage could materially deplete our assets. Moreover, any claim against us could generate negative publicity, which could decrease the demand for our products and our ability to generate revenues.

Compliance with Environmental Laws

Compliance by us with applicable environmental requirements during fiscal years 2006 and 2005 has not had a material effect upon our capital expenditures, earnings or competitive position.

Dependence on Major Customers

During fiscal 2006, two customers accounted for approximately 14% and 11% of our net sales. During fiscal 2005, the same two customers accounted for approximately 15% and 11% of our net sales.

Employees

As of March 31, 2006, we had 55 employees, of which 51 were full-time and 4 were part-time. No employee has a collective bargaining agreement with us. We believe we maintain good relations with our employees.

Incorporation and Current Subsidiaries

We were incorporated in January 1992 as a Minnesota corporation and a wholly owned subsidiary of our original parent. In February 1995, we became a stand-alone, privately held company pursuant to a Plan of Reorganization confirmed by the U.S. Bankruptcy Court. We became a reporting company pursuant to a registration statement filed with the Securities and Exchange Commission in July 1996.

Our wholly owned foreign subsidiaries and their respective principal functions are as follows:

Uroplasty BV Incorporated in The Netherlands, distributes the Urgent PC, is the manufacturer of Macroplastique, Bioplastique, VOX Implants, PTQ Implants and of all their accessories,. Products are sold primarily through distributors.

Table of Contents

Uroplasty LTD Incorporated in the United Kingdom and acts as the sole distributor of Urgent PC, Macroplastique, Bioplastique, PTQ Implants, all of their accessories, and wound care products in the United Kingdom and Ireland. Also distributes the I-Stop in the United Kingdom. Products are sold primarily through a direct sales organization.

Bioplasty BV Incorporated in The Netherlands and is the distributor of Bioplastique to subdistributors, and distributes wound care products in The Netherlands. We plan to merge this subsidiary with Uroplasty BV in fiscal 2007.

RISK FACTORS

Investing in our common stock involves a high degree of risk. You should carefully consider the risk factors set forth below and all other information contained in this Annual Report on Form 10-KSB before purchasing our common stock. If the following risks actually occur, our business, financial condition and results of operations could be seriously harmed, the price of our common stock could decline and you could lose part or all of your investment.

We continue to incur losses and may never reach profitability

We have incurred net losses in each of the last five fiscal years. As of March 31, 2006, we had an accumulated deficit of approximately \$11 million primarily as a result of costs relating to the development, including seeking regulatory approvals, and commercialization of our Macroplastique, I-Stop[®] tape, Urgent[®] PC neuromodulation system and related products. We expect our operating expenses relating to sales and marketing activities and product development, including seeking United States regulatory approval for Macroplastique, will continue to increase during the foreseeable future. To achieve profitability, we must generate substantially more revenue than we have in prior years. Our ability to achieve significant revenue growth will depend, in large part, on our ability to obtain FDA approval to market Macroplastique, and our ability to achieve widespread market acceptance for our products, which we cannot guarantee will happen. We may never realize significant revenue from the sale of our products or be profitable.

If we fail to receive or experience a significant delay in receiving regulatory approvals for sale of our products, our ability to generate revenues will be limited and our business prospects may suffer.

We cannot sell Macroplastique in the United States until we obtain the requisite FDA approvals. If we suffer delays in obtaining or fail to receive regulatory approvals, our ability to generate revenues from the sale of these products will be limited and our future growth may be significantly hampered.

In the U.S., we have submitted a pre-market approval application with respect to Macroplastique. The pre-market approval process is very expensive, uncertain and time-consuming and could materially delay our product coming to market. This submission is under review by the FDA and we continue to expect, as we indicated in July 2005, the possible approval by the FDA in late 2007. We will incur substantial expenses in connection with these regulatory activities. Even if we obtain regulatory approval, it may be only for limited uses with specific classes of patients, which may limit the market for our product.

We are primarily dependent on sales of one product and our business would suffer if sales of this product decline.

We are dependent on sales of our products that contain our Macroplastique bulking agent. Our Macroplastique product line accounted for 67% and 76%, respectively, of total net sales during fiscal 2006 and 2005. If our Macroplastique products were no longer available for sale in any key market because of regulatory, intellectual property or any other reason, our net sales from these products would significantly decline. A significant decline in our net sales could also negatively impact our product development activities and therefore our business prospects.

We are unable to predict how quickly or how broadly our products will be accepted by the market. If demand for our products fails to develop as we expect, our revenues will decline or we may be unable to increase our revenues and be profitable.

Although some our products received FDA approval, market acceptance is uncertain. Our failure to achieve sufficient market acceptance will significantly limit our ability to generate revenue and be profitable. Market acceptance of our products will depend on our ability to demonstrate the safety, clinical efficacy, perceived benefits and cost-effectiveness of our products

Table of Contents

compared to products or treatment options of our competitors, and to train physicians in the proper application of our products. We cannot assure you that we will be successful in educating the marketplace about the benefits of using our products. Even if customers accept our products, this acceptance may not translate into sales if our competitors have developed similar products that our customers prefer. If our products do not achieve increasing market acceptance in the U.S. and internationally, our revenues will decline or we may be unable to increase our revenues and be profitable. ***Our products and facilities are subject to extensive regulation with which compliance is costly and which exposes us to penalties for non-compliance. We may not be able to obtain required regulatory approvals for our products in a cost-effective manner or at all, which could adversely affect our business and results of operations.***

The production and marketing of our products and our ongoing research and development, preclinical testing and clinical trial activities are subject to extensive regulation and review by numerous governmental authorities both in the United States and abroad. U.S. and foreign regulations applicable to medical devices are wide-ranging and govern, among other things, the testing, marketing and pre-market review of new medical devices, in addition to regulating manufacturing practices, reporting, advertising, exporting, labeling and record keeping procedures. We are required to obtain FDA approval or clearance before we can market our products in the United States and certain foreign countries. The regulatory process requires significant time, effort and expenditures to bring our products to market, and we cannot assure that any of our products will be approved for sale. Any failure to obtain regulatory approvals or clearances could prevent us from successfully marketing our products, which could adversely affect our business and results of operations. Our failure to comply with applicable regulatory requirements could result in governmental agencies:

imposing fines and penalties on us;

preventing us from manufacturing or selling our products;

bringing civil or criminal charges against us;

delaying the introduction of our new products into the market;

enforcing operating restrictions;

recalling or seizing our products; or

withdrawing or denying approvals or clearances for our products.

If any or all of the foregoing were to occur, we may not be able to meet the demands of our customers and our customers may cancel orders or purchase products from our competitors, which could adversely affect our business and results of operations.

Even if we receive regulatory approval or clearance of a product, the approval or clearance could limit the uses for which we may label and promote the product, which may limit the market for our products. Further, for a marketed product, its manufacturer and manufacturing facilities are subject to periodic reviews and inspections by FDA and foreign regulatory authorities. Subsequent discovery of problems with a product, manufacturer or facility may result in restrictions on the product, manufacturer or facility, including withdrawal of the product from the market or other enforcement actions. In addition, regulatory agencies may not agree with the extent or speed of corrective actions relating to product or manufacturing problems.

If additional regulatory requirements are implemented in the foreign countries in which we sell our products, the cost of developing or selling our products may increase. In addition, we may rely on our distributors outside the United States in seeking regulatory approval to market our devices in particular countries. To the extent we do so, we are dependent on persons outside of our direct control to make regulatory submissions and secure approvals, and we do or will not have direct access to health care agencies in those markets to ensure timely regulatory approvals or prompt resolution of regulatory or compliance matters. If our distributors fail to obtain the required approvals or do not do so in a timely manner, our net sales from our international operations and our results of operations may be adversely

affected.

In addition, our business and properties are subject to federal, state and local laws and regulations relating to the protection of the environment, natural resources and worker health and safety and the use, management, storage, and disposal of hazardous substances, wastes, and other regulated materials. The costs of complying with these various environmental requirements, as they now exist or may be altered in the future, could adversely affect our financial condition and results of operations.

Table of Contents

If third parties claim that we infringe upon their intellectual property rights, we may incur liabilities and costs and may have to redesign or discontinue selling the affected product.

The medical device industry is litigious with respect to patents and other intellectual property rights. Companies operating in our industry routinely seek patent protection for their product designs, and many of our principal competitors have large patent portfolios. Companies in the medical device industry have used intellectual property litigation to gain a competitive advantage. Whether a product infringes a patent involves complex legal and factual issues, the determination of which is often uncertain. We face the risk of claims that we have infringed on third parties intellectual property rights. Our efforts to identify and avoid infringing on third parties intellectual property rights may not always be successful. Any claims of patent or other intellectual property infringement, even those without merit, could:

be expensive and time consuming to defend;

result in us being required to pay significant damages to third parties;

cause us to cease making or selling products that incorporate the challenged intellectual property;

require us to redesign, reengineer or rebrand our products, if feasible;

require us to enter into royalty or licensing agreements in order to obtain the right to use a third party s intellectual property, which agreements may not be available on terms acceptable to us or at all;

divert the attention of our management; or

result in our customers or potential customers deferring or limiting their purchases or use of the affected products until resolution of the litigation.

In addition, new patents obtained by our competitors could threaten a product s continued life in the market even after it has already been introduced.

If we are unable to adequately protect our intellectual property rights, we may not be able to compete effectively and we may not be profitable.

Our success depends in part on our ability to protect our proprietary rights to the technologies used in our products. We rely on patent protection, as well as a combination of trademark laws and confidentiality, noncompetition and other contractual arrangements to protect our proprietary technology. However, these legal means afford only limited protection and may not adequately protect our rights or permit us to gain or keep any competitive advantage. Our patents and patent applications if issued, may not be broad enough to prevent competitors from introducing similar products into the market. Our patents, if challenged or if we attempt to enforce them, may not necessarily be upheld by the courts of any jurisdiction. In addition, patent protection in foreign countries may be different from patent protection under U.S. laws and may not be favorable to us. As a result, we may not be able to compete effectively. We also rely on unpatented proprietary technology. We cannot assure you that we can meaningfully protect all of our rights in our unpatented proprietary technology or that others will not independently develop substantially equivalent products or processes or otherwise gain access to our unpatented proprietary technology. We attempt to protect our trade secrets and other unpatented proprietary technology through the use of confidentiality agreements and noncompetition agreements with our current employees and with other parties to whom we have divulged trade secrets. However, these agreements may not be enforceable or may not provide meaningful protection for our proprietary information in the event of unauthorized use or disclosure or other breaches of the agreements or in the event competitors discovery or independently develop similar proprietary information.

Product liability claims could adversely affect our business and results of operations.

The manufacture and sale of medical devices exposes us to significant risk of product liability claims, some of which may have a negative impact on our business. Our existing products were developed relatively recently and defects or risks that we have not yet identified may give rise to product liability claims. Our existing \$2 million of worldwide

product liability insurance coverage may be inadequate to protect us from any liabilities we may incur or we may not be able to maintain adequate product liability insurance at acceptable rates. If a product liability claim or series of claims is brought against us for

Table of Contents

uninsured liabilities or in excess of our insurance coverage and it is ultimately determined that we are liable, our business could suffer. Additionally, we could experience a material design or manufacturing failure in our products, a quality system failure, other safety issues or heightened regulatory scrutiny that would warrant a recall of some of our products. A recall of any of our products likely would be costly, would be uninsured and could also result in increased product liability claims. Further, while we train our physician customers on the proper usage of our products, we cannot ensure that they will implement our instructions accurately. If our products are used incorrectly by our customers, injury may result and this could give rise to product liability claims against us. Any losses that we may suffer from any liability claims, and the effect that any product liability litigation may have upon the reputation and marketability of our products, may divert management's attention from other matters and may have a negative impact on our business and our results of operations.

If we are not able to successfully scale-up production of our products, our sales and revenues will suffer.

In order to commercialize our products in the United States and international markets, we need to be able to produce, or subcontract the production, of our products in a cost-effective way on a large scale to meet demand, while maintaining high standards for quality and reliability. If we fail to successfully commercialize our products, we will not be profitable.

We may experience manufacturing and control problems as we begin to scale-up our future manufacturing operations, and we may not be able to scale-up manufacturing in a timely manner or at a reasonable cost to enable production in sufficient quantities. If we experience any of these problems, we may not be able to have our products manufactured and delivered in a timely manner.

The I-Stop sling is designed and manufactured by CL Medical in France for our distribution in the United States and the United Kingdom. If CL Medical experiences problems with manufacturing or control, encounters regulatory or compliance problems, or incurs delays, we may not receive the I-Stop product in a timely manner. This would limit our ability to generate revenues.

The loss or interruption of materials from any of our key suppliers could slow down the manufacture of our products, which would limit our ability to generate sales and revenues.

We currently purchase several key materials used in our products from single source suppliers. Our reliance on a limited number of suppliers subjects us to several risks, including an inability to obtain an adequate supply of required materials, price increases, untimely delivery and difficulties in qualifying alternative suppliers. We cannot be sure that acceptable alternative arrangements could be made on a timely basis. Additionally, the qualification of materials and processes as a result of a supplier change could be deemed as unacceptable to regulatory authorities and cause delays and increased costs due to additional test requirements. A significant interruption in the supply of materials, for any reason, could delay the manufacture and sale of our products, which would limit our ability to generate revenues.

If we are not able to maintain sufficient quality controls, approval of our products by the European Union, the FDA or other relevant authorities could be delayed or denied and our sales and revenues will suffer.

Approval of our products could be delayed by the FDA, European Union or other related authorities if our manufacturing facilities do not comply with applicable manufacturing requirements. The FDA's Quality System Regulations impose elaborate testing, control, document and other quality assurance procedures. Canada and the European Union also impose requirements on quality control systems of manufacturers, which are inspected and certified on a periodic basis and may be subject to additional unannounced inspections. Failure by us or CL Medical to comply with these requirements could prevent us from obtaining FDA approval for our products and from marketing our products in the United States. We cannot assure you that our manufacturing facilities will comply with applicable requirements on a timely basis or at all.

Even with approval to market our products in the European Union, the United States and other countries, we must continue to comply with relevant manufacturing requirements. If violations of applicable requirements are noted during periodic inspections of our manufacturing facilities, we may not be able to continue to market our products and our revenues could be materially adversely affected.

If we are not able to increase our sales force and expand our distribution channels, our sales and revenues will suffer.

To date, we have sold our products in foreign markets through a network of independent distributors and our direct sales force. Our ability to increase product sales in foreign markets will largely depend on our ability to develop and maintain relationships with our existing and additional distributors and to recruit additional sales personnel. We may not be able to attract distributors who are willing to commit the necessary resources to market and sell our products to the level of our

Table of Contents

expectations. In the United States, we have a sales organization consisting of a direct sales management group and a nationwide network of independent sales representatives and a marketing organization to market our products directly and support our distributor organizations. We anticipate continuing to expand our sales and marketing organization, as needed to support our growth. We have and will continue to incur significant continued and additional expenses to support this organization. We will need to raise additional debt or equity financing to expand our sales and marketing organizations. We have incurred and likely will incur some additional related expenses in advance of any anticipated regulatory approval, which we could not recoup if we do not receive such approval. We also may not be able to hire, train and motivate qualified sales and marketing personnel. Failure to expand our distribution and sales channels will adversely affect our sales and revenues.

If we are not able to acquire or license other products, our business and future growth prospects could suffer.

As part of our growth strategy, we intend to acquire or license additional products and product candidates for development and commercialization. The success of this strategy depends upon our ability to identify, select and acquire the right products. In fact, we have an option to acquire the assets of CystoMedix, Inc., the company that has licensed the Urgent® PC technology to us.

Any product candidate we license or acquire may require additional development efforts prior to sale, including clinical testing and approval by the FDA. Product candidates may fail to receive or experience a significant delay in receiving FDA approval. In addition, we cannot assure you that any approved products that we acquire or license will be manufactured economically, successfully commercialized or widely accepted in the marketplace. Other companies, including tho