

PRO PHARMACEUTICALS INC  
Form 10-Q  
November 07, 2008  
[Table of Contents](#)

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

Washington, D.C. 20549

**FORM 10-Q**

**x** Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended September 30, 2008

**..** 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

**PRO-PHARMACEUTICALS, INC.**

Edgar Filing: PRO PHARMACEUTICALS INC - Form 10-Q

**Nevada**  
(State or other jurisdiction  
of incorporation)

**04-3562325**  
(I.R.S. Employer  
Identification No.)

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

**02459**  
(Zip Code)

**(617) 559-0033**

(Registrant's Telephone Number, Including Area Code)

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

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

Smaller reporting company

(Do not check if a smaller reporting company)

The number of shares outstanding of the registrant's common stock as of November 7, 2008 was 47,947,609.

**Table of Contents**

**PRO-PHARMACEUTICALS, INC.**

**INDEX TO FORM 10-Q**

**FOR THE QUARTER ENDED SEPTEMBER 30, 2008**

|   | <b>PAGE</b> |
|---|-------------|
| <b>PART I FINANCIAL INFORMATION</b>   |             |
| ITEM 1. Unaudited Consolidated Financial Statements   |             |
| <u>Condensed Consolidated Balance Sheets as of September 30, 2008 and December 31, 2007</u>   | 3           |
| <u>Condensed Consolidated Statements of Operations for the Three and Nine Months Ended September 30, 2008 and September 30, 2007 and for the Cumulative Period From Inception (July 10, 2000) to September 30, 2008</u> | 4           |
| <u>Condensed Consolidated Statement of Changes in Stockholders' Deficit for the Nine Months Ended September 30, 2008</u>  | 5           |
| <u>Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2008 and September 30, 2007, and for the Cumulative Period From Inception (July 10, 2000) to September 30, 2008</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>  | 16          |
| ITEM 3. <u>Quantitative and Qualitative Disclosures about Market Risk</u>   | 22          |
| ITEM 4T. <u>Controls and Procedures</u>   | 22          |
| <b>PART II OTHER INFORMATION</b>  |             |
| ITEM 1. <u>Legal Proceedings</u>  | 22          |
| ITEM 1A. <u>Risk Factors</u>  | 22          |
| ITEM 4. Submission of Matters to a Vote of Security Holders   | 21          |
| ITEM 6. <u>Exhibits</u>   | 23          |
| <u>SIGNATURES</u>   | 24          |

**Table of Contents****PRO-PHARMACEUTICALS, INC.****(A Development-Stage Company)****CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED) (dollars in thousands except share and per share data)**

|   | September 30,<br>2008 | December 31,<br>2007 |
|---|-----------------------|----------------------|
| <b>ASSETS</b>   |                       |                      |
| <b>CURRENT ASSETS:</b>  |                       |                      |
| Cash and cash equivalents   | \$ 816                | \$ 1,319             |
| Prepaid expenses and other current assets   | 79                    | 70                   |
| <b>Total current assets</b>   | <b>\$ 895</b>         | <b>\$ 1,389</b>      |
| PROPERTY AND EQUIPMENT NET  | 48                    | 73                   |
| RESTRICTED CASH   | 62                    | 70                   |
| INTANGIBLE ASSETS NET   | 228                   | 250                  |
| <b>TOTAL ASSETS</b>   | <b>\$ 1,233</b>       | <b>\$ 1,782</b>      |
| <b>LIABILITIES AND STOCKHOLDERS DEFICIT</b>   |                       |                      |
| <b>CURRENT LIABILITIES:</b>   |                       |                      |
| Accounts payable  | \$ 160                | \$ 601               |
| Accrued expenses  | 244                   | 362                  |
| Accrued dividends payable   | 104                   |                      |
| Advances received from subscribers for Series A 12% Convertible Preferred Stock and related warrants  |                       | 1,637                |
| Advances received for equity consideration  | 200                   |                      |
| <b>Total current liabilities</b>  | <b>\$ 708</b>         | <b>\$ 2,600</b>      |
| WARRANT LIABILITIES   | 868                   | 2,069                |
| OTHER LONG TERM LIABILITIES   | 40                    | 37                   |
| <b>Total liabilities</b>  | <b>\$ 1,616</b>       | <b>\$ 4,706</b>      |
| <b>CONTINGENCIES (Note 7)</b>   |                       |                      |
| <b>STOCKHOLDERS DEFICIT:</b>  |                       |                      |
| Undesignated shares, \$0.01 par value; 10,000,000 shares authorized; 5,000,000 shares designated Series A 12% Convertible Preferred Stock and 5,000,000 shares undesignated at September 30, 2008 and December 31, 2007 | \$                    | \$                   |
| Series A 12% Convertible Preferred Stock; 5,000,000 shares designated, 1,742,500 issued and outstanding at September 30, 2008 and 1,667,500 shares subscribed, none issued and outstanding at December 31, 2007         | 704                   |                      |
| Common stock, \$0.001 par value; 200,000,000 shares authorized, 47,947,609 and 40,364,792 issued and outstanding at September 30, 2008 and December 31, 2007 respectively;  | 48                    | 40                   |
| Additional paid-in capital  | 36,547                | 32,196               |
| Deficit accumulated during the development stage  | (37,682)              | (35,160)             |
| <b>Total stockholders deficit</b>   | <b>\$ (383)</b>       | <b>\$ (2,924)</b>    |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS DEFICIT</b>   | <b>\$ 1,233</b>       | <b>\$ 1,782</b>      |

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 data)**

|   | Three Months Ended September 30, |                   | Nine Months Ended September 30, |                   | Cumulative Period   |
|---|----------------------------------|-------------------|---------------------------------|-------------------|---|
|   | 2008                             | 2007              | 2008                            | 2007              | from Inception<br>(July 10, 2000)<br>to<br>September 30, 2008 |
| <b>OPERATING EXPENSES:</b>                                |                                  |                   |                                 |                   |   |
| Research and development                                  | \$ 338                           | \$ 332            | \$ 1,504                        | \$ 1,668          | \$ 17,085   |
| General and administrative                                | 601                              | 1,036             | 2,721                           | 3,396             | 25,176  |
| Total operating loss                                      | \$ (939)                         | \$ (1,368)        | \$ (4,225)                      | \$ (5,064)        | \$ (42,261)   |
| <b>OTHER INCOME AND EXPENSE</b>                           |                                  |                   |                                 |                   |   |
| Interest income   | 5                                | 11                | 27                              | 91                | 764   |
| Interest expense  |                                  | (18)              |                                 | (343)             | (4,451)   |
| Change in fair value of convertible debt instrument       |                                  | 5                 |                                 | (1,091)           | (3,426)   |
| Change in fair value of warrant liabilities               | 1,148                            | (1,216)           | 1,863                           | (1,717)           | 11,879  |
| Total other income (expense)                              | \$ 1,153                         | \$ (1,218)        | \$ 1,890                        | \$ (3,060)        | \$ 4,766  |
| <b>NET INCOME (LOSS)</b>                                  | <b>\$ 214</b>                    | <b>\$ (2,586)</b> | <b>\$ (2,335)</b>               | <b>\$ (8,124)</b> | <b>\$ (37,495)</b>  |
| SERIES A 12% CONVERTIBLE PREFERRED STOCK DIVIDEND         | 52                               |                   | 187                             | \$                | (187)   |
| <b>NET INCOME (LOSS) APPLICABLE TO COMMON STOCK</b>       | <b>\$ 162</b>                    | <b>\$</b>         | <b>\$ (2,522)</b>               | <b>\$</b>         | <b>\$ (37,682)</b>  |
| <b>NET INCOME (LOSS) PER SHARE BASIC</b>                  | <b>\$ 0.00</b>                   | <b>\$ (0.06)</b>  | <b>\$ (0.05)</b>                | <b>\$ (0.21)</b>  |   |
| <b>WEIGHTED AVERAGE COMMON SHARES OUTSTANDING BASIC</b>   | <b>47,947,609</b>                | <b>40,364,792</b> | <b>46,402,947</b>               | <b>38,519,133</b> |   |
| <b>NET INCOME (LOSS) PER SHARE DILUTED</b>                | <b>\$ 0.00</b>                   | <b>\$ (0.06)</b>  | <b>\$ (0.05)</b>                | <b>\$ (0.21)</b>  |   |
| <b>WEIGHTED AVERAGE COMMON SHARES OUTSTANDING DILUTED</b> | <b>47,947,609</b>                | <b>40,364,792</b> | <b>46,402,947</b>               | <b>38,519,133</b> |   |

See notes to unaudited condensed consolidated financial statements.

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

(A Development-Stage Company)

**CONSOLIDATED STATEMENT OF STOCKHOLDERS DEFICIT****SIX MONTHS ENDED SEPTEMBER 30, 2008 (UNAUDITED) (dollars in thousands except share data)**

|  | Common Stock        |        | Preferred Stock     |        | Additional<br>Paid in<br>Capital | Deficit                            |                         |
|--|---------------------|--------|---------------------|--------|----------------------------------|------------------------------------|-------------------------|
|  | Number<br>of Shares | Amount | Number<br>of Shares | Amount |                                  | Accumulated                        | Total                   |
|  |                     |        |                     |        |                                  | During the<br>Development<br>Stage | Stockholders<br>Deficit |
| BALANCE, JANUARY 1, 2008   | 40,364,792          | \$ 40  |                     | \$     | \$ 32,196                        | \$ (35,160)                        | \$ (2,924)              |
| Net loss   |                     |        |                     |        |                                  | (2,335)                            | (2,335)                 |
| Series A 12% Convertible Preferred Dividend  |                     |        |                     |        |                                  | (187)                              | (187)                   |
| Series A 12% Convertible Preferred Stock issued in a February 4, 2008 private placement (net of cash issuance costs of \$52) |                     |        | 1,742,500           | 704    |                                  |                                    | 704                     |
| Common stock issued in a February 25, 2008 offering (net of cash issuance costs of \$369)                                    | 7,500,000           | 8      |                     |        | 1,036                            |                                    | 1,044                   |
| Issuance of common stock in payment of Series A 12% Convertible Preferred Dividend   | 82,817              |        |                     |        | 83                               |                                    | 83                      |
| Issuance of Common Stock Warrants  |                     |        |                     |        | 20                               |                                    | 20                      |
| Reclassification of Warrant Liabilities  |                     |        |                     |        | 2,662                            |                                    | 2,662                   |
| Stock-based compensation expense   |                     |        |                     |        | 550                              |                                    | 550                     |
| BALANCE, SEPTEMBER 30, 2008  | 47,947,609          | \$ 48  | 1,742,500           | \$ 704 | \$ 836,547                       | \$ (37,682)                        | \$ (383)                |

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              |
|   | 2008              |            | Inception                |
|   | 2007              |            | (July 10, 2000)          |
|   | 2008              | 2007       | to September 30,<br>2008 |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>  |                   |            |                          |
| Net loss  | \$ (2,335)        | \$ (8,124) | \$ (37,495)              |
| Adjustments to reconcile net loss to net cash used in operating activities:                 |                   |            |                          |
| Depreciation and amortization   | 39                | 49         | 478                      |
| Stock-based compensation expense  | 550               | 479        | 2,638                    |
| Non-cash interest expense   |                   | 328        | 4,279                    |
| Change in fair value of convertible debt instrument   |                   | 1,091      | 3,426                    |
| Change in fair value of warrant liabilities   | (1,863)           | 1,717      | (11,879)                 |
| Write off of intangible assets  | 11                |            | 181                      |
| Changes in operating assets and liabilities:  |                   |            |                          |
| Prepaid expenses and other current assets   | (9)               | 51         | (76)                     |
| Accounts payable and accrued expenses   | (559)             | 184        | 522                      |
| Other long term liabilities   | 3                 | 11         | 40                       |
| Net cash used in operating activities   | \$ (4,163)        | \$ (4,214) | \$ (37,886)              |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>  |                   |            |                          |
| Maturity of certificate of deposit  | \$                | \$ 5,000   | \$                       |
| Purchases of property and equipment   | (2)               | (2)        | (421)                    |
| Change in restricted cash   | 8                 | (11)       | (62)                     |
| Increase in patents costs and other assets  |                   | (74)       | (404)                    |
| Net cash provided by (used in) investing activities   | \$ 6              | \$ 4,913   | \$ (887)                 |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>  |                   |            |                          |
| Net proceeds from issuance of common stock and warrants                                     | \$ 3,381          | \$         | \$ 28,690                |
| Net proceeds from issuance of Series A 12% Convertible Preferred Stock and related warrants | 53                |            | 1,690                    |
| Net proceeds from issuance of convertible debt instruments                                  |                   |            | 10,621                   |
| Repayment of convertible debt instruments   |                   | (334)      | (1,641)                  |
| Proceeds from issuance of common stock warrants   | 20                |            | 20                       |
| Proceeds from shareholder advances  | 200               |            | 209                      |
| Net cash provided by (used in) financing activities   | \$ 3,654          | \$ (334)   | \$ 39,589                |
| <b>NET INCREASE IN CASH AND CASH EQUIVALENTS</b>  | <b>(503)</b>      | <b>365</b> | <b>816</b>               |
| <b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>                                       | <b>1,319</b>      | <b>773</b> |                          |



Edgar Filing: PRO PHARMACEUTICALS INC - Form 10-Q

|  |        |          |           |
|--|--------|----------|-----------|
| CASH AND CASH EQUIVALENTS, END OF PERIOD   | \$ 816 | \$ 1,138 | \$ 816    |
| SUPPLEMENTAL DISCLOSURE Cash paid for interest   | \$     | \$ 15    | \$ 114    |
| <b>NONCASH FINANCING ACTIVITIES:</b>   |        |          |           |
| Issuance of equity warrants in connection with equity offerings                        |        |          | \$ 1,172  |
| Conversion of accrued expenses into common stock                                       |        |          | \$ 303    |
| Cashless exercise of employee stock options  |        |          | \$ 74     |
| Conversion and redemptions of convertible notes and accrued interest into common stock |        | \$ 5,915 | \$ 12,243 |
| Conversion of extension costs related to convertible notes into common stock           |        |          | \$ 171    |
| Conversion of prepaid interest into common stock                                       |        | \$ (32)  |           |
| Payment of 12% Convertible Preferred dividend in common stock                          | \$ 83  |          | \$ 83     |
| Dividends payable on preferred stock   | \$ 104 |          | \$ 104    |
| Issuance of warrants to induce conversion of notes payable                             |        |          | \$ 503    |
| Issuance of stock to acquire Pro-Pharmaceuticals-NV                                    |        |          | \$ 107    |

See notes to unaudited condensed consolidated financial statements.

---

**Table of Contents**

**PRO-PHARMACEUTICALS, INC.**

**(A DEVELOPMENT-STAGE COMPANY)**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**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, 2008 and the results of its operations for the three and nine months ended September 30, 2008 and September 30, 2007 and the cumulative period from inception (July 10, 2000) through September 30, 2008, the statement of stockholders' deficit for the nine months ended September 30, 2008 and its cash flows for the nine months ended September 30, 2008 and September 30, 2007 and for the cumulative period from inception (July 10, 2000) to September 30, 2008. 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, 2007.

The financial statements of the Company have been prepared assuming that the Company will continue as a going concern. As shown in the unaudited condensed consolidated financial statements, the Company incurred net losses of approximately \$37.5 million for the cumulative period from inception (July 10, 2000) through September 30, 2008. 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 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 (July 10, 2000) through September 30, 2008, the Company has raised approximately \$41.2 million in capital through sale and issuance of common stock, common stock purchase warrants, and debt securities in public and private offerings. From inception (July 10, 2000) through September 30, 2008, the Company has used approximately \$37.9 million of cash in its operations. At September 30, 2008, the Company had approximately \$816,000 of cash and cash equivalents to fund future operations. The Company believes there is sufficient cash only to fund operations only into December 2008. If the Company is unsuccessful in raising additional capital before the end of December 2008, the Company may be required to cease operations or seek bankruptcy protection. In light of the Company's current financial position and the uncertainty of raising sufficient capital to achieve its business plan, there is substantial doubt about the Company's ability to continue as a going concern. The accompanying financial statements do not include any adjustments that might result if such circumstances arise.

In June 2007, the Company received a notice from the American Stock Exchange (Amex) that it is reviewing the Company's eligibility for continued listing of its common stock. Specifically, the notice cited that the Company does not comply with the Amex's minimum \$2 million stockholders' equity when combined with losses from continuing operations and/or net losses in two of the last three years set forth in Section 1003 (a) (i) of the Amex Company Guide. To facilitate the review, the Company was asked to provide a specific plan and timeframe to achieve and sustain compliance with all Amex market listing requirements. In July 2007, the Company timely submitted a plan to the Amex to return to compliance within the specified period of time. In response to the Company's plan to achieve and sustain compliance with the listing requirements, the exchange granted the Company an extension until October 13, 2008 to regain compliance with the standards. On May 14, 2008, the Amex notified the Company that it does not meet a continued listing standard because it had less than \$4 million in stockholders' equity and has sustained losses from continuing operations and/or net losses in three of the four most recent fiscal years. In October 2008, the Company provided an update to the Amex relating to the fact that the Company did not meet the minimum requirement for stockholders' equity. Failure to make progress consistent with the plan or to regain compliance with the continued listing standards could result in being de-listed from the Amex. The Company is subject to periodic review by Amex Staff.

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, dependence on third-party manufacturing, dependence on third-party sales and marketing, 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

## Edgar Filing: PRO PHARMACEUTICALS INC - Form 10-Q

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.

**Table of Contents**

*Impact of New Accounting Standards* In September 2006, the Financial Accounting Standards Board ( 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 are separately disclosed by level within the fair value hierarchy. In February 2008, the FASB decided that an entity need not apply this standard to nonfinancial assets and liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis until the subsequent year. The Company adopted SFAS No. 157 in the first quarter of fiscal year 2008. See Note 4. We believe there is sufficient cash to fund operations only into December 2008.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities ( SFAS No. 159 ). SFAS No. 159 provides entities with an option to report selected financial assets and liabilities at fair value, with the objective to reduce both the complexity in accounting for financial instruments and the volatility in earnings caused by measuring related assets and liabilities differently. The Company adopted SFAS No. 159 in the first quarter of fiscal year 2008. SFAS No. 159 had no impact on the Company's financial statements as the Company did not elect the option to value selected assets or liabilities at fair value.

In June 2007, the FASB issued Emerging Issues Task Force 07-3, Accounting for Nonrefundable Advance Payments for Goods or Services Received for Use in Future Research and Development Activities ( EITF 07-3 ). EITF 07-3 provides that nonrefundable advance payments for goods or services that will be used or renders for future research and development activities should be deferred and capitalized. The Company adopted EITF 07-3 in the first quarter of fiscal year 2008. This standard had no material effect on the Company.

**2. STOCK-BASED COMPENSATION**

The Company accounts for stock-based compensation in accordance with SFAS No. 123(R), Share-Based Payment ( SFAS No. 123(R) ), which was adopted January 1, 2006. The Company has two stock-based compensation plans where the Company's common stock has been made available for option grants as part of the Company's compensation programs (the Plans ). These Plans are described in more detail in the 2007 Form 10-K.

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

|   | Cumulative         |               |               |
|---|--------------------|---------------|---------------|
|   | Period from        |               |               |
|   | Inception          |               |               |
|   | (July 10, 2000) to |               |               |
|   | Nine Months Ended  |               |               |
|   | September 30,      | September 30, | September 30, |
|   | 2008               | 2007          | 2008          |
| Risk-free interest rate                     | 2.65%              | 4.45%         | 3.04%         |
| Expected life of the options                | 5 years            | 5 years       | 3.99 years    |
| Expected volatility of the underlying stock | 95%                | 95%           | 92%           |
| Expected dividend rate                      | None               | None          | None          |
| Expected forfeiture rate                    | None               | None          | None          |

Stock-based compensation expense for both employees and non-employees totaled approximately \$148,000 and \$159,000 for the three months ended September 30, 2008 and 2007. For the nine months ended September 30, 2008 and 2007, stock-based compensation expense was approximately \$550,000 and \$479,000, respectively.

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 three and nine month periods ended September 30, 2008 Board members earned approximately 11,000 and 34,000 stock options respectively.

The following table summarizes the stock option activity in the equity incentive plans from January 1, 2008 through September 30, 2008:

Edgar Filing: PRO PHARMACEUTICALS INC - Form 10-Q

|                                 | Shares    | Exercise Price<br>Per Share | Weighted Average<br>Exercise Price |
|---------------------------------|-----------|-----------------------------|------------------------------------|
| Outstanding, January 1, 2008    | 3,677,854 | \$ 0.63-4.05                | \$ 2.93                            |
| Granted                         | 1,130,000 | 0.38-0.44                   | 0.44                               |
| Options expired                 | (100,354) | 2.96-4.05                   | 3.64                               |
| Outstanding, September 30, 2008 | 4,707,500 | \$ 0.38-4.05                | \$ 2.32                            |

**Table of Contents**

The following tables summarize information about stock options outstanding at September 30, 2008:

| Options Outstanding |        |                  |                                 | Options Exercisable                                 |                  |                                 |   |
|---------------------|--------|------------------|---------------------------------|---|------------------|---------------------------------|---|
| Exercise Price      |        | Number of Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life (Years) | Number of Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life (Years) |
| \$0.38              | \$0.70 | 1,355,000        | \$ 0.48                         | 4.31  | 1,123,000        | \$ 0.48                         | 4.47  |
| \$1.01              | \$2.70 | 955,500          | 1.32                            | 3.94  | 575,503          | 1.52                            | 4.27  |
| \$2.92              | \$4.05 | 2,397,000        | 3.75                            | 4.05  | 2,302,003        | 3.75                            | 4.12  |
|                     |        | 4,707,500        | \$ 2.32                         | 4.10  | 4,000,506        | \$ 2.52                         | 4.24  |

During the three month periods ended September 30, 2008 and September 30, 2007 no options were granted. During the nine month periods ended September 30, 2008 and 2007, respectively, 1,130,000 options and 823,500 options were granted. The weighted average grant date fair value for options granted during the nine month period ended September 30, 2008 and 2007 was \$0.32 and \$0.74, respectively. The total fair value of options vested during the three month period ended September 30, 2008 was approximately \$58,000. No options vested during the three month period ended September 30, 2007. The total fair value of options vested during the nine month periods ended September 30, 2008 and 2007 was approximately \$656,000 and \$403,000, respectively. During the three month periods ended September 30, 2008 and 2007, 50,000 and no options expired, respectively. During the nine month period ended September 30, 2008 and 2007, 100,354 and 85,000 options expired, respectively. During the three and nine month periods ended September 30, 2008 no options were cancelled. During the three and nine month periods ended September 30, 2007, no and 45,000 options were cancelled.

As of September 30, 2008, there were 706,994 unvested options which will vest as follows: 186,667 in 2008, 307,663 in 2009, and 212,664 in 2010. Total expected unrecognized compensation cost related to such unvested options is approximately \$357,000 which is expected to be recognized over a weighted average period of 0.63 years. As of September 30, 2008, there was no intrinsic value of outstanding options based on the Company's closing common stock price of \$0.20 at September 30, 2008. As of September 30, 2008, there was no intrinsic value of outstanding fully vested options and exercisable options based on the Company's closing common stock price of \$0.20 at September 30, 2008.

No cash was received from employees as a result of employee stock option exercises during the three and nine month periods ended September 30, 2008 and 2007 and during the cumulative period from inception (July 10, 2000) to September 30, 2008. No options were exercised during the three and nine month periods ended September 30, 2008 and 2007 and the intrinsic value of options exercised for the cumulative period from inception was approximately \$74,000 resulting from the cashless exercise of options in October 2003.

**3. ACCRUED EXPENSES**

Accrued expenses consist of the following:

|                              | September 30,<br>2008<br>(000) | December 31,<br>2007<br>(000) |
|------------------------------|--------------------------------|-------------------------------|
| Legal and accounting fees    | \$ 70                          | \$ 14                         |
| Scientific and clinical fees | 71                             | 214                           |
| Accrued payroll and vacation | 82                             | 97                            |
| Other                        | 21                             | 37                            |
| <b>Total</b>                 | <b>\$ 244</b>                  | <b>\$ 362</b>                 |



**Table of Contents****4. COMMON STOCK WARRANTS**

The following table summarizes information with regard to outstanding warrants issued in connection with equity and debt financings and as compensation as of September 30, 2008. The 2001 Placement Agents, February 4, 2008 Transaction and February 25, 2008 Transaction, Cork Investments and Investor Relations Group Warrants are classified as equity. The October 2003, April 2004, August 2004 and February 2006 Transaction Warrants do not meet the requirements of equity classification and are classified as liabilities:

| Issued in Connection With       | Number Issued | Exercise Price | Exercisable Date   | Expiration Date    |
|---------------------------------|---------------|----------------|--------------------|--------------------|
| October 2003 Transaction (1)    |               |                |                    |                    |
| Investor Warrants               | 657,293       | \$ 3.19        | October 2, 2003    | October 2, 2008    |
| April 2004 Transaction (2)      |               |                |                    |                    |
| Investor Warrants               | 618,056       | \$ 3.23        | April 7, 2004      | April 7, 2009      |
| August 2004 Transaction         |               |                |                    |                    |
| Investor Warrants               | 2,000,000     | \$ 4.20        | February 13, 2005  | August 12, 2009    |
| Placement Agent Warrants        | 100,000       | \$ 4.20        | February 13, 2005  | August 12, 2009    |
| February 2006 Transaction       |               |                |                    |                    |
| Investor Warrants (3)           | 9,985,097     | \$ 0.50        | August 15, 2006    | August 14, 2011    |
| Placement Agent Warrants(4)     | 998,508       | \$ 0.50        | August 15, 2006    | August 14, 2011    |
| 2001 Placement Agents           | 110,000       | \$ 3.50        | February 1, 2002   | February 1, 2012   |
| February 4, 2008 Transaction    |               |                |                    |                    |
| \$1.50 Investor Warrants        | 1,742,500     | \$ 1.50        | August 3, 2008     | February 4, 2012   |
| \$2.00 Investor Warrants        | 1,742,500     | \$ 2.00        | August 3, 2008     | February 4, 2012   |
| \$1.50 Placement Agent Warrants | 8,400         | \$ 1.50        | August 3, 2008     | February 4, 2012   |
| February 25, 2008 Transaction   |               |                |                    |                    |
| \$0.70 Investor Warrants        | 7,500,000     | \$ 0.70        | August 25, 2008    | August 25, 2013    |
| \$0.63 Investor Warrants        | 3,000,000     | \$ 0.63        | August 25, 2008    | December 26, 2008  |
| \$0.70 Placement Agent Warrants | 206,250       | \$ 0.70        | August 25, 2008    | August 25, 2013    |
| Investor Relations Group        | 39,000        | \$ 0.50        | September 30, 2008 | September 30, 2011 |
| Cork Investments                | 300,000       | \$ 1.00        | July 2, 2008       | July 2, 2011       |
| Total                           | 29,007,604    |                |                    |                    |

- (1) The exercise price of the warrants has been adjusted from \$5.29 per share to \$3.19 per share due to the subsequent issuance of equity related instruments.
- (2) The exercise price of the warrants has been adjusted from \$5.30 per share to \$3.23 per share due to the subsequent issuance of equity related instruments.
- (3) The exercise price of the warrants has been adjusted from \$3.35 per share to \$0.50 per share and an additional 8,494,784 shares of the Company's common stock are issuable upon exercise of the warrants due to subsequent issuance of equity related instruments.
- (4) The exercise price of the warrants has been adjusted from \$3.35 per share to \$0.50 per share and an additional 849,477 shares of the Company's common stock are issuable upon exercise of the warrants due to subsequent issuance of equity related instruments.

*October 2003, April 2004, August 2004 Transactions* In connection with the October 2003, April 2004 and August 2004 PIPE transactions, the Company issued common stock purchase warrants. The warrants were accounted for as freestanding derivative instruments in the consolidated balance sheet under the caption "Warrant Liabilities". Changes in fair value are recognized as either a gain or loss in the consolidated statement of operations under the caption "Gain/loss on change in fair value of warrant liabilities".

*February 2006 Transaction* In February 2006, the Company issued \$10 million in aggregate principal amount of convertible debentures ( "Debentures" ) together with warrants to investors and the placement agent to purchase approximately 1,490,313 and 149,031 shares respectively, of the Company's common stock.

The warrants are accounted for as freestanding derivative instruments in the consolidated balance sheet under the caption "Warrant Liabilities". Changes in fair value are recognized as either a gain or loss in the consolidated statement of operations under the caption "Gain/loss on change in fair value of warrant liabilities".





**Table of Contents**

The exercise price of the investor and placement agent 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 exercise price. In the event of a dilutive issuance of common stock or common stock equivalents, the exercise price is reduced to equal the lower price per share of the subsequent transaction.

In March 2007, under a Waiver and Exchange Agreement with six of the seven remaining holders of the Debentures, the exercise price of the investor warrants was reduced to \$1.00 per share, which, in accordance with the anti-dilution provisions of the warrants would result in an additional 3,152,014 shares of the Company's common stock becoming issuable upon exercise of the investor warrants. Pursuant to the same agreement, approximately \$3.9 million of the then remaining \$4.4 million of outstanding Debentures was discharged in exchange for shares of the Company's common stock. In connection with the February 2008 finance transactions, as a result of the anti-dilution provisions of the warrant instruments, the exercise price of the investor and placement agent warrants was reduced to \$0.50 and an additional 5,342,770 and 849,477 shares of the Company's common stock are issuable, respectively, upon exercise of the investor and placement agent warrants. The Warrant Agreement contains a provision that limits the number of shares that can be issued to holders of the warrant.

*February 4, 2008 Transaction* On February 4, 2008, the Company closed a private placement in which it sold units of securities comprised of 1,742,500 shares of Series A 12% Convertible Preferred Stock together with warrants to purchase 1,742,500 shares of common stock exercisable at \$1.50 and warrants to purchase 1,742,500 shares of common stock exercisable at \$2.00. In addition the Company issued to placement agents warrants to purchase 8,400 shares of common stock at \$1.50. The warrants were accounted for as freestanding derivative instruments in the consolidated balance sheet formerly under the caption "Warrant Liabilities". These warrants were originally classified as a liability because the February 2006 warrants contain an anti-dilution provision in the event of a subsequent dilutive issuance and the potential number of shares issuable exceeded the Company's authorized shares. Changes in fair value were recognized as either a gain or loss in the consolidated statement of operations under the caption "Gain/loss on change in fair value of warrant liabilities". In the second quarter of 2008, the warrants were reclassified to equity as a result of an amendment to the Company's articles of incorporation approved at the May 21, 2008 annual meeting of shareholders increasing the Company's authorized common stock from 100,000,000 to 200,000,000 shares (the "Charter Amendment"). The Charter Amendment authorization of the additional shares coupled with a provision in the February 2006 warrants limiting the number of shares that can be issued to holders of the February 2006 warrants, ensures that sufficient shares are available for issuance upon exercise of these warrants, thereby enabling them to be reclassified from a liability to equity. Through May 21, 2008, these warrants were marked to market resulting in a reduction in warrant liabilities in the balance sheet and an offsetting credit to change in fair value of warrant liabilities in the statement of operations in the amount of approximately \$100,000. The remaining fair value of approximately \$502,000 was credited to additional paid-in capital in the balance sheet.

*February 25, 2008 Transaction* On February 25, 2008, the Company sold to investors 7,500,000 shares of its common stock, 7,500,000 warrants to purchase shares of common stock exercisable at \$0.70, and 3,000,000 warrants to purchase shares of common stock exercisable at \$0.63. In addition, the Company issued to a placement agent 206,250 warrants to purchase shares of common stock at \$0.70. The warrants were accounted for as freestanding derivative instruments in the consolidated balance sheet under the caption "Warrant Liabilities". These warrants were originally classified as a liability because the February 2006 warrants contain an anti-dilution provision in the event of a subsequent dilutive issuance and the potential number of shares issuable exceeded the Company's authorized shares prior to the Charter Amendment. Changes in fair value were recognized as either a gain or loss in the consolidated statement of operations under the caption "Gain/loss on change in fair value of warrant liabilities". In the second quarter of 2008 the warrants were reclassified to equity as a result of the Charter Amendment. The Charter Amendment authorization of the additional shares coupled with a provision in the February 2006 warrants limiting the number of shares that can be issued to holders of the February 2006 warrants ensures that sufficient shares are available for issuance upon exercise of these warrants, thereby enabling them to be reclassified from a liability to equity. Through May 21, 2008, these warrants were marked to market resulting in a reduction in warrant liabilities in the balance sheet and an offsetting credit to change in fair value of warrant liabilities in the statement of operations in the amount of approximately \$356,000. The remaining fair value of approximately \$2,160,000 was credited to additional paid-in capital in the balance sheet.

*Investor Relations Group* In May 2008 the Company entered into an agreement with Investor Relations Group ( "IRG" ) for IRG to provide investor relations services to the Company in exchange for cash and warrants on a monthly basis. On September 30, 2008 the Company terminated the agreement under the provisions of the agreement. During the effective contract period IRG earned 39,000 warrants valued at approximately \$3,000. The expense associated with these warrants was calculated using the Black-Scholes option-pricing model and charged to stock compensation expense. Assumptions used to value these warrants are included in the table provided below. The warrants are exercisable at \$0.50 per share for a period of three years.

*Cork Investments* On July 2, 2008 the Company issued 300,000 warrants to Howard Crosby in exchange for \$20,000. The warrants are exercisable for common stock at \$1.00 per share for a period of three years. The \$20,000 was credited to Additional paid in capital.

## Edgar Filing: PRO PHARMACEUTICALS INC - Form 10-Q

Effective January 1, 2008, the Company adopted SFAS No. 157. SFAS No. 157 establishes a new framework for measuring fair value and requires fair value to be determined based on the exchange price that would be received for an asset or paid to transfer

**Table of Contents**

a liability (an exit price) in the principal or most advantageous market for the asset and or liability in an orderly transaction between market participants. SFAS No. 157 establishes market or observable inputs as the preferred source of values, followed by assumptions based on hypothetical transactions in the absence of market inputs. The valuation techniques and disclosures required by SFAS No. 157 are determined by the following hierarchy:

Level 1 - Quoted prices for identical instruments in active markets.

Level 2 - Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model derived valuations whose inputs are observable or whose significant value drivers are observable.

Level 3 - Significant inputs to the valuation model are unobservable.

The Company uses the Black-Scholes pricing model to calculate fair value of its warrant liabilities.

Key assumptions used to apply these models as of September 30, 2008 and December 31, 2007 are as follows:

|   | Warrants           |           |                   |            |
|---|--------------------|-----------|-------------------|------------|
|   | September 30, 2008 |           | December 31, 2007 |            |
| Risk free interest rate                   | 1.02-2.24%         |           | 3.16% - 3.34%     |            |
| Expected life                             | 0.01years          | 2.87years | 0.75 years        | 3.62 years |
| Expected volatility of common share price | 95%                |           | 95%               |            |
| Common share price                        | \$                 | 0.20      | \$                | 0.70       |

Below is a summary of our fair value measurements at September 30, 2008:

| Description | Value at<br>9/30/2008<br>(000) | Quoted Prices in<br>Active Markets for<br>Identical<br>Assets<br>(Level 1)<br>(000) | Significant<br>Other<br>Observable<br>Inputs (Level 2)<br>(000) | Significant<br>Unobservable<br>Inputs (Level 3)<br>(000) |
|-------------|--------------------------------|---|---|--|
|             |                                |   |   |  |
| Totals      | \$ 868                         |   | \$ 868  |  |

|   | Fair Value of<br>Warrant<br>Liabilities<br>(000) |
|---|--|
| Balance December 31, 2007   | \$ 2,069   |
| Fair value assigned to February 4, 2008 transaction warrants upon issuance                        | 986  |
| Fair value assigned to February 25, 2008 transaction warrants upon issuance                       | 2,337  |
| Change in fair value of warrant liabilities   | 587  |
| Balance March 31, 2008  | \$ 5,979   |
| Change in fair value of warrant liabilities reclassified to Stockholders Deficit at May 21, 2008. | (456)  |
| Reclassification of warrant liabilities to Stockholders Deficit                                   | (2,662)  |
| Change in fair value of warrant liabilities   | (845)  |

## Edgar Filing: PRO PHARMACEUTICALS INC - Form 10-Q

|   |    |         |
|---|----|---------|
| Balance June 30, 2008                       | \$ | 2,016   |
| Change in fair value of warrant liabilities |    | (1,148) |
| Balance September 30, 2008                  |    | 868     |

### 5. STOCKHOLDERS (DEFICIT)

*February 4, 2008 Private Placement.* On February 4, 2008, the Company closed a private placement begun in October 2007 of its Series A 12% Convertible Preferred Stock ( Series A Preferred ) and related warrants. In this transaction, the Company sold units of securities at \$1.00 per unit, each unit comprised of (i) one share of Series A Preferred, (ii) a warrant to purchase one share of common stock for \$1.50, and (iii) a warrant to purchase one share of common stock for \$2.00. Each share of the Series A Preferred is entitled to dividends at the rate of 12% per annum payable at the Company's option in cash or shares of common stock valued at the higher of \$1.00 per share or 100% of the value weighted average price of the Company's share price for the 20 consecutive trading days prior to the applicable dividend payment date. Dividends are payable semi-annually on March 30 and September 30. The dividend paid on the initial dividend payment date is calculated from the date the Company deposited each subscription advance.

**Table of Contents**

The shares of Series A Preferred are entitled to vote as a class with the Company's common stock and each share of Series A Preferred is convertible at any time to one share of common stock, subject to adjustment in the event of a stock dividend, stock split or combination, reclassification or similar event. The Company has the right to require conversion if the closing price of the common stock exceeds \$3.00 for 15 consecutive trading days and a registration statement covering the resale of the shares of common stock issuable upon conversion of the Series A Preferred is then in effect. Each warrant is exercisable solely for cash beginning August 3, 2008 and expires on February 4, 2012. The exercise price of each warrant is adjustable in the event of a stock split or stock combination, capital reorganization, merger or similar event.

As of December 31, 2007, the Company had received subscription advances of approximately \$1,667,500 for the units of securities described above. In 2008, the Company received additional subscription advances of approximately \$75,000 resulting in total gross proceeds of approximately \$1,742,500. On February 4, 2008 the Company closed the private placement. The Company incurred approximately \$52,000 of cash transaction costs resulting in net cash proceeds of approximately \$1,690,500. In addition, the Company incurred approximately \$2,000 of costs for warrants issued to placement agents. Proceeds of approximately \$984,000 were allocated to investor warrants using the Black-Scholes method with the following assumptions as of February 4, 2008: risk free interest rate 2.51%, volatility 95%, fair market value of the company's common stock on February 4, 2008, and the share price on the closing date of the transaction of \$0.59.

The warrants were determined to have the characteristics of derivative liabilities in accordance with SFAS No. 133, Accounting for Derivative Financial Instruments Indexed to and Potentially Settled in a Company's Own Stock and were originally accounted for as liabilities.

In the second quarter of 2008, these warrants liabilities were marked to market as a consequence of the Charter Amendment increasing the Company's authorized shares of common stock, resulting in a change in fair value of warrant liabilities gain in the Statement of Operations of approximately \$100,000 and reclassified to Stockholders' Equity. Please see Footnote 4. Common Stock Warrants for further explanation.

*February 25, 2008 Offering* On February 25, 2008, the Company closed an offering in which it sold to investors (i) an aggregate of 7,500,000 shares of the Company's common stock at \$0.50 per share, (ii) warrants, which expire on August 25, 2013, to purchase an aggregate of 7,500,000 share of the Company's common stock at an exercise price of \$0.70 per share, and (iii) warrants, which expire on December 26, 2008, to purchase an aggregate of 3,000,000 shares of the Company's common stock at an exercise price of \$0.67 per share. In addition, the Company issued to a placement agent warrants, which expire on August 25, 2013, to purchase 206,250 shares of the Company's common stock at an exercise price of \$0.70. The warrants are exercisable beginning on August 25, 2008. The warrants provide for cashless exercise if at any time during the term of the warrants if there is no effective registration statement for the issuance or resale of the underlying warrant shares. The exercise price of each warrant is adjustable in the event of a stock split or stock combination, capital reorganization, merger or similar event.

The Company received net proceeds of approximately \$3,381,000 net of cash transaction costs of approximately \$369,000. In addition the Company incurred approximately \$56,000 of costs for warrants issued to a placement agent. Proceeds of approximately \$2,281,000 were allocated to investor warrants using the Black-Scholes method with the following assumptions as of February 25, 2008.

|   | 5 Year Warrants Exercisable at \$0.70 |       | Warrants Exercisable at \$0.63 |       |
|---|---------------------------------------|-------|--------------------------------|-------|
| Risk Free Interest Rate                         |                                       | 2.94% |                                | 2.13% |
| Volatility                                      |                                       | 95%   |                                | 95%   |
| Fair market value of the Company's common stock | \$                                    | 0.40  | \$                             | 0.40  |

The warrants were determined to have the characteristics of derivative liabilities in accordance with SFAS No. 133, Accounting for Derivative Financial Instruments Indexed to and Potentially Settled in a Company's Own Stock and were originally accounted for as liabilities.

In the second quarter of 2008, these warrants liabilities were marked to market as a consequence of the Charter Amendment increasing the Company's authorized shares of common stock, resulting in a change in fair value of warrant liabilities gain in the Statement of Operations of approximately \$356,000 and reclassified to Stockholders' Equity. Please see Footnote 4. Common Stock Warrants for further explanation.

On July 2, 2008 the Company issued 300,000 warrants to Cork Investments in exchange for \$20,000. The warrants are exercisable for common stock at \$1.00 per share for a period of three years. The \$20,000 was credited to Additional paid in capital.

**Table of Contents****6. EARNINGS PER SHARE**

Basic income or 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 assumed conversion of convertible preferred stock using the if converted method. The computation of diluted net income or loss per share does not assume the issuance of common shares that have an anti-dilutive effect on net income or loss per share. For the three and nine month periods ended September 30, 2008 and September 30, 2007, all stock options, warrants and potential shares related to conversion of the convertible debentures were excluded from the computation of diluted net income or loss per share as their effect is anti-dilutive. Dilutive shares which could exist pursuant to the exercise of outstanding stock options and warrants and conversion of preferred stock at September 30, 2008, and 2007, totaled 35,457,604 and 12,029,561 respectively.

|  | Three Months Ended |                | Nine Months Ended |                |
|--|--------------------|----------------|-------------------|----------------|
|  | September 30,      |                | September 30,     |                |
|  | 2008               | 2007           | 2008              | 2007           |
| Net Income (loss) applicable to common stock-basic and diluted | \$ 162,000         | \$ (2,586,000) | \$ (2,522,000)    | \$ (8,124,000) |
| Weighted average common shares outstanding-basic and diluted   | 47,947,609         | 40,364,792     | 46,402,947        | 38,519,133     |
| Net Income (loss) per Share-basic and diluted                  | \$ 0.00            | \$ (0.06)      | \$ (0.05)         | \$ (0.21)      |

**7. INCOME TAXES**

As of December 31, 2007, the total amount of unrecognized tax benefits was approximately \$1,082,000. Of this amount, approximately \$890,000 would impact the effective tax rate prior to the adjustment for the Company's valuation allowance. The Company has not recognized an adjustment to the deficit accumulated during the development stage for unrecognized tax benefits because the Company has recorded a full valuation allowance against net operating loss carryforwards.

The Company is subject to U.S. Federal income tax as well as income tax of certain state jurisdictions. The tax years ranging from 2000 through 2007 remain open to examination by various taxing jurisdictions as the statute of limitations has not expired.

The Company recognizes accrued interest and penalties related to unrecognized tax benefits in income tax expense. Since the Company's net deferred tax assets and the unrecognized tax benefits determined under FASB Interpretation No. 48, Accounting for Uncertainty in Income taxes (FIN 48), would not result in a tax liability, the Company has not accrued for any interest and penalties relating to these unrecognized tax benefits.

**8. CONTINGENCIES**

In January 2004, David Platt, Ph.D., 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. GlycoGenesys asserted counterclaims against the Company and Dr. Platt alleging tortious interference, misappropriation of proprietary rights, defamation and unfair competition, and sought monetary damages and injunctive relief related to the Company's intellectual property. Prospect Therapeutics, Inc. (formerly known as Marlborough Research and Development, Inc.) purchased certain assets including this lawsuit from the GlycoGenesys bankruptcy estate and continues prosecuting the counterclaims against the Company and Dr. Platt. Concluding that certain disputes of fact could not be resolved as a matter of law, the Court on May 27, 2008 denied the Company's motion for summary judgment. Prospect Therapeutics informed the Court that it does not seek monetary damages other than recovery of attorney fees. The lawsuit is expected to proceed to trial in March 2009. The Company and Dr. Platt believe the counterclaims are without merit and intend to contest them vigorously. Additionally, the Company believes that any impact on the financial statements is neither probable nor reasonably estimable and therefore no amounts have been recorded as of September 30, 2008.

The Company's Board of directors authorized the indemnification of Dr. Platt for the expenses of his defense of the counterclaims. In the nine months ended September 30, 2008, Company incurred no expenses in connection with this defense. Through September 30, 2008 the Company has incurred cumulative expenses of approximately \$438,000 in connection with this defense.

In January 2005, the Company filed a request with the U.S. Patent and Trademark Office for an inter partes re-examination of U.S. Patent No. 6,680,306 (306) now owned by Prospect Therapeutics, Inc. because the Company believes that the invention claimed in this patent is anticipated by other inventions (technically, prior art), including the Company's U.S. Patent No. 6,645,946 for DAVAN<sup>®</sup> All the Patent Office has agreed with the Company's argument throughout the re-examination that all claims stated in the 306 patent are anticipated by prior art. The

## Edgar Filing: PRO PHARMACEUTICALS INC - Form 10-Q

Company believes that the actions of the Patent Office support the Company's position that the invention claimed in the DAVANAT<sup>®</sup> patent is prior art relative to the 306 patent.

On January 30, 2008, Custom Equity Research, Incorporated (d/b/a Summer Street Research Partners) ( Summer Street ) filed a lawsuit against the Company in the Superior Court of the Commonwealth of Massachusetts, alleging claims for breach of contract, declaratory judgment and unjust enrichment arising out of an engagement letter under which Summer Street agreed to



**Table of Contents**

provide institutional investment placement services to the Company. Summer Street claims it is entitled to a placement fee for each placement made during the term of the agreement and for each issuance of securities made or agreed to be made by the Company from October 17, 2007 through November 16, 2008. The Company initially responded to the lawsuit with a motion to dismiss, which the Court denied on June 23, 2008, finding that the letter agreement was ambiguous with respect to Summer Street's entitlement to compensation. The Court also denied Summer Street's motion for a prejudgment attachment and trustee process, preliminarily finding that Summer Street was not likely to prevail on any of its claims. On July 3, 2008, the Company filed its answer, denying Summer Street's material allegations. No trial date has been set for this matter. The Company believes the lawsuit is without merit and intends to contest it vigorously. Additionally, the Company believes that any impact on the financial statements is neither probable nor reasonably estimable and therefore no amounts have been recorded as of September 30, 2008.

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.

**9. SUBSEQUENT EVENTS**

In October 2008, a number of holders representing approximately 73% of the outstanding Convertible Debenture warrants agreed to waive their right to receive cash, at their option, in the event of a fundamental transaction related to the Company. Because they now receive the same treatment as common shareholders, the warrant liability associated with these warrants will be reclassified to stockholders equity in the fourth quarter of 2008. In addition, the placement agent waived all future rights to the anti-dilution provisions of the warrant agreement.

On October 31, 2008, the Company's Board of Directors authorized Medi-Pharmaceuticals, Inc., a wholly-owned Nevada subsidiary, to undertake a joint venture in corporate form, the purpose of which is to deploy technology the Company owns as well as original technology developed by the joint venture for use in nutraceutical cardiovascular therapies. The joint venture authorization included the following steps: (i) a merger of FOD Enterprises, Inc., a Nevada corporation, with and into Medi-Pharmaceuticals, which will be the surviving corporation, following which the Company would own 10% of its capital stock; and (ii) a license to Medi-Pharmaceuticals of worldwide perpetual rights to commercialize all of the Company's polysaccharide technology exclusively in the field of cardiovascular therapies (both preventive and therapeutic). The Company's Board authorized terms of the license to include royalties payable to the Company equal to 10% of net revenues received by Medi-Pharmaceuticals from products based on the licensed technology, \$1 million of such royalties to be advanced within 6 months of the effective date of the license failing which the Company may terminate the license with a reversion to the Company of the licensed technology. Neither the Company nor the joint venture entities have entered into definitive documentation for these transactions.

\* \* \* \* \*

---

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

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 about 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 debt 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 the discovery, development, and commercialization of first-in-class, targeted therapeutic compounds for advanced treatment of cancer, liver, microbial and inflammatory diseases. Our initial focus is the development of a new generation of anti-cancer treatments using carbohydrate compounds to increase survival and improve the quality of life for cancer patients. DAVANAT<sup>®</sup>, our lead pipeline candidate, is a new, proprietary chemical entity that is currently in Phase II trials for first-line treatment of colorectal and biliary cancers.

Our proprietary compounds also can be used to treat other serious diseases such as liver and kidney fibrosis. We entered into research collaborations with the Mount Sinai School of Medicine to study the anti-fibrotic effects of our novel carbohydrate compounds on liver fibrosis and with Brigham and Women's Hospital to evaluate the anti-fibrotic effects of these compounds to treat acute and chronic kidney disease. Our first-in-class, novel carbohydrate compounds significantly reduced collagen expression and reversed fibrosis in animal models. Whereas previously, *in vitro* data indicated a reversal of fibrosis markers, in this proof-of-concept animal study, the compounds clearly reduced collagen expression and reversed liver fibrosis.

In the second quarter, we completed an important step toward the submission of a New Drug Application (NDA) for DAVANAT<sup>®</sup> by submitting a Drug Master File (DMF) with the U.S. Food and Drug Administration (FDA). The DMF filing is a key development for the commercialization of DAVANAT<sup>®</sup>. Our goal is to file an NDA for DAVANAT<sup>®</sup> in 2009. We also plan to file an Investigational New Drug (IND) application for an anti-hypoxia drug to be used in combination with DAVANAT<sup>®</sup> and 5-FU to treat advanced solid tumors, including new indications such as head & neck and breast cancers.

Upon approval by the appropriate regulatory authorities, we may commence commercial marketing and distribution of the product. 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 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 currently have no source of revenue and have incurred significant losses to date. We have incurred net losses of \$37,495,000 for the cumulative period from inception (July 10, 2000) through September 30, 2008. 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 and warrant liabilities 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.

We have an ongoing Phase II clinical trial for colorectal cancer patients being treated with DAVANAT<sup>®</sup>, 5-FU, Leucovorin and Avastin<sup>®</sup>. The Phase II clinical trial for biliary cancer patients was halted due to financial constraints.

In April 2007, we received comments about additional chemical, manufacturing, control and testing information the FDA requested to review our plans for submitting an NDA for DAVANAT<sup>®</sup>, to be administered intravenously in combination with 5-FU for colorectal cancer. We submitted additional information to the FDA in 2008 and have a pre-NDA meeting scheduled for December 22, 2008.



**Table of Contents**

In June 2007, we received a notice from the American Stock Exchange ( Amex ) that it is reviewing our eligibility for continued listing of our common stock. Specifically, the notice cited that we do not comply with the Amex s minimum \$2 million stockholders equity as set forth in Section 1003(a)(i) of the Amex Company Guide. To facilitate the review, we were asked to provide a specific plan and timeframe to achieve and sustain compliance with all Amex market listing requirements. In July 2007, we timely submitted a plan to the Amex to return to compliance within the specified period of time. In response to our plan, the Amex granted us an extension until October 13, 2008 to regain compliance with the standards. On May 14, 2008, the Amex notified us that we do not meet a continued listing standard because we had less than \$4 million in stockholders equity and had sustained losses from continuing operations and/or net losses in three of the four most recent fiscal years. In October 2008, we provided an update to the Amex relating to the fact that we did not meet the minimum requirement for stockholders equity. Failure to make progress consistent with the plan or to regain compliance with the continued listing standards could result in being de-listed from the Amex. We are subject to periodic review by Amex staff.

Through September 30, 2008, we have raised approximately \$41 million in capital principally through the sale and issuance of common stock, common stock warrants and debt securities in public and private offerings. From inception (July 10, 2000) through September 30, 2008, we used cash of approximately \$37.9 million for our operations. At September 30, 2008, we had approximately \$816,000 of cash and cash equivalents available to fund future operations, which we believe is sufficient only to fund our operations into December 2008.

Because we lack revenue and must continue our research and development, we need to identify new sources of capital and complete financing transactions in order to continue our business.

**Results of Operations****Three Months Ended September 30, 2008 Compared to Three Months Ended September 30, 2007**

*Research and Development Expenses.* Research and development expenses were approximately \$338,000 during the three months ended September 30, 2008, as compared to approximately \$332,000 incurred during the three months ended September 30, 2007 or an increase of approximately \$6,000. 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 pre-clinical 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 have one product candidate DAVANA<sup>®</sup> in clinical trials at this time. 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.

Our research and development expenses for the three months ended September 30, 2008 as compared to the three months ended September 30, 2007 were as follows:

|   | <b>Three Months Ended<br/>September 30, (000)</b> |               |
|---|---|---------------|
|   | <b>2008</b>                                       | <b>2007</b>   |
| Direct external expenses                    |   |               |
| Clinical programs                           | \$ 7  | \$ 83         |
| Pre-clinical activities                     | 152   | 76            |
| All other research and development expenses | 179   | 173           |
|   | <b>\$ 338</b>                                     | <b>\$ 332</b> |

Clinical trial expenses decreased by approximately \$76,000. The decrease is due principally to lower activity in the Phase II colorectal and biliary cancer trials as we focused on filing our DAVANAT<sup>®</sup> Drug Master File ( DMF ) with the FDA. Pre-clinical expenses increased by approximately \$76,000. Approximately \$102,000 was due to increased expenses associated with filing our NDA. This increase was offset by approximately \$26,000 in lower activity related to all other research activities. All other research and development expense increased by approximately \$6,000. Stock compensation expense increased by approximately \$15,000 and was offset by lower payroll expense. We expect to

## Edgar Filing: PRO PHARMACEUTICALS INC - Form 10-Q

file, with the FDA, for approval to sell DAVANAT® in 2009. We plan to focus our research and development spending on preparing an investigational New Drug ( IND ) filing for DAVANAT-FU and an anti-hypoxia compound and on our Phase II clinical trial. In July 2008, we reduced payroll as employees took salary reductions of approximately 50%, and in September took another 50% reduction so that we may extend our cash runway as further discussed in the liquidity section of this report. As a result, we expect cash research and development expense to decrease in the fourth quarter 2008 as compared to the third quarter of 2008.

**Table of Contents**

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 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 find 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. Due to these uncertainties, accurate and meaningful estimates of the ultimate cost to bring a product to market, the timing of costs, 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 approximately \$601,000 during the three months ended September 30, 2008, as compared to \$1,036,000 incurred during the three months ended September 30, 2007 or a decrease of approximately \$435,000. 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 decrease, approximately \$402,000 was due to lower legal expenses associated with our trade secret litigation. Stock compensation expense decreased by approximately \$26,000 and an additional \$14,000 was due to lower payroll expenses. In July 2008, we reduced payroll as management took salary reductions of approximately 50% and another 50% reduction in September and reduced other general and administrative expenses in light of our financial situation as further discussed in the liquidity section. As a result, we expect cash general and administrative expense to decrease in the fourth quarter of 2008 as compared to the third quarter of 2008.

*Other Income and Expense.* Other income and expense for the three months ended September 30, 2008, was income of approximately \$1,153,000 as compared to expense of approximately \$1,218,000 for the three months ended September 30, 2007. Of the approximately \$2,371,000 increase in other income and expense, approximately \$2,359,000 was due to change in non-cash fair value associated with our warrant liabilities and convertible debt instrument. Interest expense decreased by approximately \$18,000 due to our convertible debenture which was outstanding in 2007 and no longer outstanding in 2008. Interest income decreased by approximately \$6,000 due to lower cash balances

***Nine Months Ended September 30, 2008 Compared to Nine Months Ended September 30, 2007***

*Research and Development Expenses.* Research and development expenses were approximately \$1,504,000 during the nine months ended September 30, 2008 or a decrease of approximately \$164,000 as compared to \$1,668,000 incurred during the nine months ended September 30, 2007. Please see explanation above contained in the three month analysis for a description of what is included in research and development expenses.

Our research and development expenses for the nine months ended September 30, 2008, as compared to the nine months ended September 30, 2007 were as follows:

|   | <b>Nine Months Ended<br/>September 30, (000)</b> |                 |
|---|--|-----------------|
|   | <b>2008</b>                                      | <b>2007</b>     |
| Direct external expenses                    |  |                 |
| Clinical programs                           | \$ 201   | \$ 674          |
| Pre-clinical activities                     | 594  | 282             |
| All other research and development expenses | 709  | 712             |
|   | <b>\$ 1,504</b>                                  | <b>\$ 1,668</b> |

Clinical trial costs decreased by approximately \$473,000. The decrease is due principally to lower activity in the Phase II colorectal and biliary cancer trials as we focused on filing our DAVANAT® DMF with the FDA, as well as filing an IND and preparations for our NDA filing. Pre-clinical expenses in 2008 increased by approximately \$312,000 compared to 2007. Of this amount approximately \$569,000 was due to expense associated with filing our DMF. This increase was offset by approximately \$257,000 in lower activity related to all other research activities. Other research and development costs remained essentially unchanged. Stock based compensation increased by approximately \$112,000. This was offset by a decrease in payroll expense of approximately \$111,000 due principally to salary reductions.

## Edgar Filing: PRO PHARMACEUTICALS INC - Form 10-Q

*General and Administrative Expenses.* General and administrative expenses were \$2,721,000 during the nine months ended September 30, 2008, or a decrease of approximately \$675,000 as compared to \$3,396,000, incurred during the nine months ended September 30, 2007. Please see explanation above contained in the three month analysis for a description of what is included in general and administrative expenses. Accounting and legal expenses decreased by approximately \$621,000, payroll expense decreased by approximately \$35,000 and stock based compensation decreased by approximately \$41,000. All other expenses increased by a net of approximately \$22,000.

---

**Table of Contents**

*Other Income and Expense.* Other income and expense for the nine months ended September 30, 2008, was income of \$1,890,000 as compared to expense of \$3,060,000 for the nine months ended September 30, 2007. Of the approximately \$4,950,000 increase in other income and expense, approximately \$4,671,000 was due to fair value accounting associated with our convertible debenture and our warrant liabilities. Interest expense decreased by approximately \$343,000 due to our convertible debenture which was outstanding in 2007 and no longer outstanding in 2008 and interest income decreased by approximately \$64,000 due to lower cash balances.

**Recent Developments**

On October 31, 2008, our Board of Directors authorized Medi-Pharmaceuticals, Inc., our wholly-owned Nevada subsidiary, to undertake a joint venture in corporate form, the purpose of which is to deploy technology we own as well as original technology developed by the joint venture for use in nutraceutical cardiovascular therapies. The joint venture authorization included the following steps: (i) a merger of FOD Enterprises, Inc., a Nevada corporation, with and into Medi-Pharmaceuticals, which will be the surviving corporation, following which we would own 10% of its capital stock; and (ii) a license to Medi-Pharmaceuticals of worldwide perpetual rights to commercialize all of our polysaccharide technology exclusively in the field of cardiovascular therapies (both preventive and therapeutic). Our Board authorized terms of the license to include royalties payable to us equal to 10% of net revenues received by Medi-Pharmaceuticals from products based on the licensed technology, \$1 million of such royalties to be advanced within 6 months of the effective date of the license failing which we may terminate the license with a reversion to us of the licensed technology. Neither we nor the joint venture entities have entered into definitive documents for these transactions.

**Liquidity and Capital Resources**

As described above in the Overview and elsewhere in this Quarterly Report on Form 10-Q, we are a development stage Company 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, 2008, we raised a total of \$41 million from these offerings and had approximately \$816,000 of available cash and cash equivalents.

Net cash used in operations decreased by approximately \$51,000 to approximately \$4.16 million for the nine months ended September 30, 2008, from \$4.21 million for the nine months ended September 30, 2007. Cash operating expenses decreased by approximately \$903,000 and were offset by an increase in working capital needs of approximately \$803,000. Interest income decreased by approximately \$64,000 and cash interest expense decreased by approximately \$15,000.

Net cash provided by investing activities was approximately \$6,000 as compared to approximately \$4.91 million in the same period for 2007. The decrease is due principally to the maturity of a \$5 million certificate of deposit in the first nine months of 2007. Approximately \$2,000 was used for purchase of plant and equipment in the nine months ended September 30, 2008, the same amount as used in the nine months ended September 30, 2007. No amount was used for patent costs during the nine months of 2008 as compared to a use of approximately \$74,000 during the same period in 2007. Restricted cash decreased by approximately \$8,000 during the nine months ended September 30, 2008 and was an increase of approximately \$11,000 during the same period in 2007.

Cash provided by financing activities was approximately \$3.65 million in the nine months ended September 30, 2008, as compared to a use of approximately \$334,000 to make scheduled repayments of our convertible debenture in the nine months ended September 30, 2007.

On February 25, 2008, we closed an offering resulting in net proceeds of approximately \$3.38 million from the sale of an aggregate of 7,500,000 shares of common stock at \$0.50 per share, (ii) warrants, with a term of five years, to purchase an aggregate of 7,500,000 shares of common stock at an exercise price of \$0.70 per share, and (iii) warrants, with a term of four months, to purchase an aggregate of 3,000,000 shares of common stock at an exercise price of \$0.67 per share. We also issued 206,250 warrants with an exercise price of \$0.70 and a term of 5 years to a placement agent in this transaction. Additional information about this transaction is set forth in our Annual Report filed on Form 10-K with the SEC for the year ended December 31, 2007.

On February 4, 2008, we closed a private placement begun in October 2007 of Series A 12% Convertible Preferred Stock (the Series A Preferred ) and related warrants to accredited investors. In this transaction, we sold, at \$1.00 per unit, 1,742,500 units of securities, each unit comprised of (i) one share of Series A 12% Convertible Preferred Stock, (ii) a warrant to purchase one share of common stock for \$1.50, and (iii) a warrant to purchase one share of common stock for \$2.00. Net proceeds from this transaction were approximately \$1.6 million. Approximately \$53,000 of the proceeds were received in 2008.

During the nine months ended September 30, 2008, we received \$20,000 for warrant subscriptions. On July 2, 2008, we issued 300,000 warrants exercisable at \$1.00 per share with a term of three years in exchange for the \$20,000. In the third quarter, we received \$200,000 for equity consideration to be determined at a later date.





**Table of Contents**

At September 30, 2008, cash and cash equivalents on hand was approximately \$816,000. In July of 2008, in order to conserve cash, we reduced payroll as management took salary reductions of approximately 50% and took another 50% reduction in salary in September and significantly reduced other cash expenses. As a result of these reductions, we believe our cash operating expense in the fourth quarter will be lower than the third quarter of 2008. We have implemented these reductions to provide additional time for us to raise cash through a debt or equity based financing or through partnerships with bio-pharmaceutical companies. We believe there is sufficient cash to fund operations only into December 2008. We believe we will be able to obtain additional financing despite the economic downturn; 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. If we are unsuccessful in raising additional capital before the end of December, we may be required to cease operations or seek bankruptcy protection.

**Table of Contents****Payments Due Under Contractual Obligations**

The following table summarizes the payments due under our contractual obligations at September 30, 2008, and the effect such obligations are expected to have on liquidity and cash flow in future periods:

| Contractual Obligations                          | Total  | Payments due by period (000) |           |           | More than 5 years |
|--|--------|------------------------------|-----------|-----------|-------------------|
|  |        | Less than 1 year             | 1-3 years | 3-5 years |                   |
| Operating leases                                 | \$ 776 | \$ 265                       | \$ 511    |           |                   |
| Total payments due under contractual obligations | \$ 776 | \$ 265                       | \$ 511    | \$        | \$                |

On May 1, 2006 we entered into an operating lease for office space. The lease commenced on August 11, 2006, extends for five years and terminates on September 30, 2011. The lease provides for annual base rental payments of \$235,000 in the first year, increasing in each subsequent lease year to \$244,000, \$253,000, \$263,000 and \$273,000 respectively. In addition to base rental payments included in the contractual obligations table above, 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 option 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 lease, a commercial bank has issued a letter of credit collateralized by cash we have on deposit with the bank of approximately \$59,000. Additionally, we have a non-cancellable lease for a car which expires in January 2011.

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, terms of existing contracts, our observance of trends in the industry, information available from other outside sources and on various other factors that we believe to be appropriate under the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

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 of our critical accounting policies, please refer to our 2007 Annual Report on Form 10-K.

**Effects of Recently Adopted Accounting Pronouncements**

In September 2006, the Financial Accounting Standards Board ( 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 are separately disclosed by level within the fair value hierarchy. In February 2008, the FASB decided that an entity need not apply this standard to non-financial assets and liabilities that are recognized or disclosed at fair value in the financial statements on a non-recurring basis until the subsequent year. We adopted SFAS No. 157 in the first quarter of fiscal year 2008. There was no impact on our financial statements. We currently have warrant liabilities which are measured at fair value at each reporting period using assumptions that are

fully disclosed.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities ( SFAS No. 159 ). SFAS No. 159 provides entities with an option to report selected financial assets and liabilities at fair value, with the objective to reduce both the complexity in accounting for financial instruments and the volatility in earnings caused by measuring related assets and liabilities differently. We adopted SFAS No. 159 in the first quarter of fiscal year 2008. We currently report warrant liabilities at fair value. We have not elected to report any other assets or liabilities at fair value.

---

## **Table of Contents**

In June 2007, the FASB issued EITF 07-3. EITF 07-3 provides that non-refundable advance payments for goods or services that will be used or renders for future research and development activities should be deferred and capitalized. We adopted EITF 07-3 in the first quarter of 2008.

### **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, 2008, we had approximately \$868,000 of outstanding warrant liabilities. We account for the 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 4T. 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 and internal control over financial reporting (as defined in the SEC rules promulgated under the Securities Exchange Act of 1934). Based on this evaluation, our CEO and CFO concluded that (i), as of September 30, 2008, our disclosure controls and procedures were effective, and (ii) during the quarter ended September 30, 2008, no change in our internal control over financial reporting has materially affected, or is likely to materially affect, our internal control over financial reporting.

## **PART II OTHER INFORMATION**

### **Item 1. Legal Proceedings**

In January 2004, David Platt, Ph.D., our Chairman and Chief Executive Officer, filed a lawsuit in Massachusetts Superior Court against GlycoGenesys, Inc. for various claims including breach of contract. GlycoGenesys asserted counterclaims against us and Dr. Platt alleging tortious interference, misappropriation of proprietary rights, defamation and unfair competition, and sought monetary and injunctive relief related to our intellectual property. Prospect Therapeutics, Inc. (formerly known as Marlborough Research and Development, Inc.) purchased certain assets including this lawsuit from the GlycoGenesys bankruptcy estate and continues prosecuting the counterclaims against us and Dr. Platt. Concluding that certain disputes of fact could not be resolved as a matter of law, the court on May 27, 2008 denied our motion for summary judgment. Prospect Therapeutics informed the Court that it does not seek monetary damages other than recovery of attorney fees. The lawsuit is expected to proceed to trial in March 2009. We believe the lawsuit is without merit and intend to contest it vigorously.

In January 2005, we filed a request with the U.S. Patent and Trademark Office for an inter partes re-examination of U.S. Patent No. 6,680,306 now owned by Prospect Therapeutics, Inc. because we believe that the invention claimed in this patent is anticipated by other inventions (technically, prior art), including our U.S. Patent No. 6,645,946 for DAVANAT®. The Patent Office has agreed with our argument throughout the re-examination that all claims stated in the 306 patent are anticipated by prior art. We believe that the actions of the Patent Office support our position that the invention claimed in the DAVANAT® patent is prior art.

On January 30, 2008, Custom Equity Research, Incorporated (d/b/a Summer Street Research Partners) (Summer Street) filed a lawsuit against us in the Superior Court of the Commonwealth of Massachusetts, alleging claims for breach of contract, declaratory judgment and unjust enrichment arising out of an engagement letter under which Summer Street agreed to provide institutional investment placement services to us. Summer Street claims it is entitled to a placement fee for each placement made during the term of the agreement and for each issuance of securities made or agreed to be made by us from October 17, 2007 through November 16, 2008. We initially responded to the lawsuit with a motion to dismiss, which the Court denied on June 23, 2008, finding that the letter agreement was ambiguous with respect to Summer Street's entitlement to compensation. The Court also denied Summer Street's motion for a prejudgment attachment and trustee process, preliminarily finding that Summer Street was not likely to prevail on any of its claims. On July 3, 2008, we filed our answer, denying Summer Street's material allegations. The parties are currently engaged in discovery and no trial date has been set for this matter. We believe the lawsuit is without merit and intend to contest it vigorously. Additionally, we believe that any impact on the financial statements is neither probable nor reasonably estimable and therefore no amounts have been recorded as of September 30, 2008.

**Item 1A. Risk Factors**

The risks we face, as set forth Item 1A, Risk Factors, of Part I of our Annual Report on Form 10-K for the year ended December 31, 2007, have not changed materially during the nine months ended September 30, 2008.

**Table of Contents**

**Item 6. Exhibits**

**Exhibit**

**Number Description of Document**

|        |  |
|--------|--|
| 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 |

\* Filed herewith.

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

**Table of Contents**

**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 7, 2008.

PRO-PHARMACEUTICALS, INC.

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

/s/ Anthony D. Squeglia  
Name: Anthony D. Squeglia  
Title: Chief Financial Officer