

Cardiogenesis Corp /CA
Form 10-Q
May 10, 2010

Table of Contents

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

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

For the quarterly period ended March 31, 2010.

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

**For the transition period from _____ to _____
Commission file number 0-28288**

CARDIOGENESIS CORPORATION
(Exact name of registrant as specified in its charter)

California

77-0223740

(State of incorporation or organization)

(I.R.S. Employer
Identification Number)

11 Musick

Irvine, California 92618

(Address of principal executive offices)

(949) 420-1800

(Issuer's telephone number)

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
o

(Do not check if a smaller reporting company)

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

Yes No

As of April 30, 2010, there were 46,678,866 shares of the registrant's common stock, no par value, outstanding.

**CARDIOGENESIS CORPORATION
TABLE OF CONTENTS**

	Page
<u>PART I</u>	
FINANCIAL INFORMATION	
<u>Item 1. Financial Statements:</u>	
<u>Condensed consolidated balance sheets as of March 31, 2010 (unaudited) and December 31, 2009 (audited)</u>	3
<u>Unaudited condensed consolidated statements of operations for the three months ended March 31, 2010 and 2009</u>	4
<u>Unaudited condensed consolidated statements of cash flows for the three months ended March 31, 2010 and 2009</u>	5
<u>Notes to unaudited condensed consolidated financial statements</u>	6
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	13
<u>Item 4(T). Controls and Procedures</u>	16
<u>PART II</u>	
OTHER INFORMATION	
<u>Item 1. Legal Proceedings</u>	18
<u>Item 6. Exhibits</u>	18
<u>Signatures</u>	19
Certifications	
<u>EX-31.1</u>	
<u>EX-31.2</u>	
<u>EX-32.1</u>	
<u>EX-32.2</u>	

Table of Contents

**PART I
FINANCIAL INFORMATION**

Item 1. Financial Statements

**CARDIOGENESIS CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands)**

	March 31, 2010 (unaudited)	December 31, 2009 (audited)
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 2,227	\$ 2,568
Accounts receivable, net of allowance for doubtful accounts of \$6	1,688	933
Inventories	720	914
Prepays and other current assets	279	253
Total current assets	4,914	4,668
Property and equipment, net	302	341
Other assets, net	9	9
Total assets	\$ 5,225	\$ 5,018
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 229	\$ 127
Accrued salaries and related	716	604
Accrued liabilities	303	299
Deferred revenue	793	744
Note payable	35	88
Current portion of capital lease obligations	10	9
Total current liabilities	2,086	1,871
Capital lease obligations, less current portion	11	14
Total liabilities	2,097	1,885
Commitments and contingencies		
Shareholders' equity:		
Preferred stock: no par value; 5,000 shares authorized; none issued and outstanding		
Common stock: no par value; 75,000 shares authorized; 45,739 and 45,549 shares issued and outstanding, respectively	174,245	174,217
Accumulated deficit	(171,117)	(171,084)
Total shareholders' equity	3,128	3,133

Total liabilities and shareholders equity	\$	5,225	\$	5,018
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See accompanying notes.

3

Table of Contents

CARDIOGENESIS CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF
OPERATIONS
(in thousands, except per share amounts)
(unaudited)

	Three months ended	
	March 31,	
	2010	2009
Net revenues	\$ 3,233	\$ 2,852
Cost of revenues	528	536
Gross profit	2,705	2,316
Operating expenses:		
Research and development	288	288
Sales and marketing	1,731	1,469
General and administrative	699	856
Total operating expenses	2,718	2,613
Operating loss	(13)	(297)
Other income (expense):		
Interest expense	(1)	(10)
Interest income		1
Total other expense, net	(1)	(9)
Loss before income taxes	(14)	(306)
Provision for income taxes	4	8
Net loss	\$ (18)	\$ (314)
Net loss per share:		
Basic	\$ (0.00)	\$ (0.01)
Diluted	\$ (0.00)	\$ (0.01)
Weighted average shares outstanding:		
Basic	45,551	45,487
Diluted	45,551	45,487

See accompanying notes.

Table of Contents

CARDIOGENESIS CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Three months ended March 31,	
	2010	2009
Cash flows from operating activities:		
Net loss	\$ (18)	\$ (314)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	75	75
Stock-based compensation expense	61	44
Changes in operating assets and liabilities:		
Accounts receivable	(753)	(95)
Inventories	172	11
Prepays and other current assets	(26)	32
Accounts payable	102	22
Accrued liabilities	66	27
Deferred revenue	49	(4)
Net cash used in operating activities	(272)	(202)
Cash flows from investing activities:		
Acquisition of property and equipment	(14)	(6)
Proceeds from the sale of marketable securities		75
Net cash (used in) provided by investing activities	(14)	69
Cash flows from financing activities:		
Payments on note payable	(53)	
Payments on capital lease obligations	(2)	(1)
Net cash used in financing activities	(55)	(1)
Net decrease in cash and cash equivalents	(341)	(134)
Cash and cash equivalents at beginning of period	2,568	2,907
Cash and cash equivalents at end of period	\$ 2,227	\$ 2,773
Supplemental schedule of cash flow information:		
Interest paid	\$ 1	\$ 1
Taxes paid	\$ 12	\$ 5
Supplemental schedule of non-cash investing and financing activities:		
Financing of property and equipment	\$	\$ 12

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Reclassification of inventories to property and equipment	\$ 22	\$ 28
Estimated fair value of shares surrendered to pay for tax withholding recorded to common stock	\$ 33	\$
Estimated fair value of shares surrendered to pay for tax withholding recorded to accumulated deficit	\$ 15	\$

See accompanying notes.

5

Table of Contents

CARDIOGENESIS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Nature of Operations:

Cardiogenesis Corporation (Cardiogenesis or the Company) was founded in 1989 to design, develop, and distribute surgical lasers and single-use fiber optic laser delivery systems (handpieces) for the treatment of cardiovascular disease. Currently, Cardiogenesis emphasis is on the development of products for transmyocardial revascularization (TMR), a treatment for cardiac ischemia in patients with severe angina.

Cardiogenesis markets its products for sale primarily in the United States and operates in a single segment.

2. Summary of Significant Accounting Policies:

Interim Financial Information:

The accompanying unaudited condensed consolidated financial statements have been prepared by the Company in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information, and pursuant to the instructions to Form 10-Q and Article 8 of Regulation S-X promulgated by the Securities and Exchange Commission (SEC). Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statement presentation. In the opinion of management, all adjustments (consisting primarily of normal recurring accruals) considered necessary for a fair presentation have been included. The Company has evaluated subsequent events through the filing date of this Form 10-Q, and determined that no subsequent events have occurred that would require recognition in the condensed consolidated financial statements or disclosure in the notes thereto other than as disclosed in the accompanying notes. These unaudited condensed consolidated financial statements should be read in conjunction with the Company s audited consolidated financial statements and notes thereto for the year ended December 31, 2009, contained in the Company s Annual Report on Form 10-K, as filed with the SEC.

These unaudited condensed consolidated financial statements contemplate the realization of assets and the satisfaction of liabilities in the normal course of business. Cardiogenesis has incurred significant losses and as of March 31, 2010 it had an accumulated deficit of \$171.1 million. Management believes its cash balance as of March 31, 2010 and expected results of operations are sufficient to meet the Company s capital and operating requirements for the next 12 months.

However, the Company may require additional financing in the future if revenues are not as expected or the Company s costs exceed its estimates. There can be no assurance that the Company will be able to obtain additional debt or equity financing if and when needed or on terms acceptable to the Company. Any additional debt or equity financing may involve substantial dilution to the Company s shareholders, restrictive covenants or high interest costs. The failure to raise needed funds on sufficiently favorable terms could have a material adverse effect on the Company s business, operating results and financial condition. The Company s long term liquidity also depends upon its ability to increase revenues from the sale of its products and achieve consistent profitability. The failure to achieve these goals could have a material adverse effect on the business, operating results and financial condition.

Net Earnings (Loss) Per Share:

Basic earnings (loss) per share (BEPS) is computed by dividing the net income (loss) by the weighted average number of common shares outstanding for the period. Diluted earnings (loss) per share (DEPS) is computed giving effect to all dilutive potential common shares that were outstanding during the period. Dilutive potential common shares consist of incremental shares issuable upon the exercise of stock options and warrants using the treasury stock method. The computation of DEPS does not assume conversion, exercise or contingent exercise of securities that would have an anti-dilutive effect on earnings.

For the three months ended March 31, 2010, there were approximately 431,000 potentially dilutive shares that were excluded from diluted loss per share as their effect would have been anti-dilutive for the period then ended. For the three months ended March 31, 2009, there were no potentially dilutive shares.

Table of Contents*Use of Estimates:*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates made in preparing the consolidated financial statements include (but are not limited to) the determination of the allowance for bad debt, inventory reserves, valuation allowance relating to deferred tax assets, warranty reserve, the assessment of future cash flows in evaluating long-lived assets for impairment and assumptions used in fair value determination of stock-based compensation.

Risks and Concentrations:

Cardiogenesis sells its products primarily to hospitals and other healthcare providers in North America, Europe and Asia. Cardiogenesis performs ongoing credit evaluations of its customers and generally does not require collateral. Although Cardiogenesis maintains allowances for potential credit losses that it believes to be adequate, a payment default on a significant sale could materially and adversely affect its operating results and financial condition. At March 31, 2010, as a result of a capital equipment sale which occurred late in the quarter, one customer individually accounted for 26% of gross accounts receivable and 17% of quarterly net revenues. At December 31, 2009, no customer individually accounted for more than 10% of gross accounts receivable. For the quarter ended March 31, 2009, two customers accounted for 12% and 11% of net revenues, respectively.

As of March 31, 2010, approximately \$969,000 of the Company's cash and cash equivalents were maintained in money market mutual funds, and approximately \$1,258,000 of the Company's cash and cash equivalents were maintained at a major financial institution in the United States. At times, deposits held with the financial institution may exceed the amount of insurance provided by the Federal Deposit Insurance Corporation (the FDIC), which provides deposit coverage with limits up to \$250,000 per owner through December 31, 2013. Generally, these deposits may be redeemed upon demand and, therefore, are believed to bear low risk.

After giving effect to the increased FDIC insurance, at March 31, 2010, the Company's uninsured cash totaled approximately \$1,999,000.

The Company outsources the manufacturing and assembly of its handpieces to a single contract manufacturer. The Company also outsources the manufacturing of its laser systems to a different single contract manufacturer.

Certain components of laser units and fiber-optic handpieces are generally acquired from multiple sources. Other laser and fiber-optic components and subassemblies are purchased from single sources. Although the Company has identified alternative vendors, the qualification of additional or replacement vendors for certain components or services is a lengthy process. Any significant supply interruption would have a material adverse effect on the Company's ability to manufacture its products and, therefore, would harm its business. The Company intends to continue to qualify multiple sources for components that are presently single sourced.

Revenue Recognition:

Cardiogenesis recognizes revenue on product sales upon shipment of the products when the price is fixed or determinable and when collection of sales proceeds is reasonably assured. Where purchase orders allow customers an acceptance period or other contingencies, revenue is recognized upon the earlier of acceptance or removal of the contingency.

Revenues from sales to distributors and agents are recognized upon shipment when there is evidence of an arrangement, delivery has occurred, the sales price is fixed or determinable and collection of the sales proceeds is reasonably assured. The contracts regarding these sales do not include any rights of return or price protection clauses.

Table of Contents

The Company, at times, will loan laser consoles to hospitals and charge an additional amount (the Premium) over the stated list price on its handpieces in exchange for the use of the laser console. In accordance with the accounting standards for leases, these arrangements are recorded as leases as they convey the right to use the laser console over the period of time the customers are purchasing handpieces. The loaned laser consoles are classified as operating leases and are transferred from inventory to property and equipment upon commencement of the loan. In addition, the Premium is considered contingent rent, and therefore, such amounts allocated to the lease of the laser console are recognized as revenue when the contingency is resolved. In these instances, the contingency is resolved upon the sale of the handpiece.

Cardiogenesis enters into contracts to sell its products and services and, while the majority of its sales agreements contain standard terms and conditions, there are agreements that contain multiple elements or non-standard terms and conditions. As a result, significant contract interpretation is sometimes required to determine the appropriate accounting, including whether the deliverables specified in a multiple element arrangement should be treated as separate units of accounting for revenue recognition purposes and, if so, how the contract value should be allocated among the deliverable elements and when to recognize revenue for each element. The Company recognizes revenue for multiple element arrangements, such as sales of lasers and handpieces, by allocating revenue for each respective element based on its selling price and when revenue recognition criteria for each element have been met.

In addition to the standard product warranty, the Company periodically offers extended warranties to its customers in the form of product maintenance services. Service agreements on its equipment are typically sold separately from the sale of the equipment. In accordance with the accounting standards for warranties, revenues on these service agreements are recognized ratably over the life of the agreement, typically one to three years.

Segment Disclosures:

The Company operates in one segment. The principal market for the Company's products is in the United States. International sales occur primarily in Europe, Mexico and Asia and amounted to approximately \$40,000 and \$73,000 for the three months ended March 31, 2010 and 2009, respectively. International sales represented 1% and 3% of total sales for the three months ended March 31, 2010 and 2009, respectively. The majority of international sales are denominated in U.S. Dollars. All of the Company's long-lived assets are located in the United States.

Recent Accounting Pronouncements:

In September 2009, the Financial Accounting Standards Board (FASB) issued an update to its accounting guidance regarding multiple-deliverable revenue arrangements. The guidance addresses how to measure and allocate consideration to one or more units of accounting. Specifically, the guidance requires that consideration be allocated among multiple deliverables based on relative selling prices. The guidance establishes a selling price hierarchy of (1) vendor-specific objective evidence, (2) third-party evidence and (3) estimated selling price. This guidance is effective for annual periods beginning on or after June 15, 2010 but may be early adopted as of the beginning of an annual period. The Company adopted this guidance on January 1, 2010 and it did not have a material impact on its consolidated financial statements.

In January 2010, the FASB issued an update to its accounting guidance regarding fair value measurement and disclosure. The guidance affects the disclosures made about recurring and non-recurring fair value measurements. This guidance is effective for annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010. Early adoption is permitted. The Company is currently evaluating the impact that this guidance will have on its consolidated financial statements.

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

Table of Contents**3. Inventories:**

Inventories are stated at the lower of cost (first-in, first-out) or market and consist of the following (in thousands):

	March 31, 2010 (unaudited)	December 31, 2009 (audited)
Raw materials	\$ 141	\$ 141
Work-in-process	393	192
Finished goods	186	581
Total	\$ 720	\$ 914

4. Stock-Based Compensation:

In accordance with the accounting standards for stock-based compensation, the Company recognizes all share-based payments to employees, including grants of employee stock options and restricted stock grants, based upon their fair values. The Company uses the Black-Scholes option pricing model to estimate the grant-date fair value of share-based awards with the fair value determined at the date of grant. The financial statement effect of forfeitures is estimated at the time of grant and revised, if necessary, if the actual effect differs from those estimates.

Description of Plans

The Company's stock option plans provide for grants of options to employees and directors of the Company to purchase the Company's shares at the fair value of such shares on the grant date (based on the closing price of the Company's common stock). The options vest immediately or up to four years beginning on the grant date and have a 10-year term. The terms of the option grants are determined by the Company's Board of Directors. As of March 31, 2010, the Company is authorized to issue up to an aggregate of 12,125,000 shares under these plans.

The Company's 1996 Employee Stock Purchase Plan (the "ESPP") was adopted in April 1996 and amended in July 2005. A total of 1,500,000 common shares are reserved for issuance under the ESPP, as amended. The ESPP permits employees to purchase common shares at a price equal to the lower of 85% of the fair market value of the common stock at the beginning of each offering period or the end of each offering period. The ESPP has two offering periods, the first one from May 16 through November 15 and the second one from November 16 through May 15. Employee purchases are nonetheless limited to 15% of eligible cash compensation, and other restrictions regarding the amount of annual purchases also apply. The Company suspended the ESPP effective at the end of the November 16, 2008 offering period.

The Company has treated the ESPP as a compensatory plan.

Summary of Assumptions and Activity

The fair value of stock-based awards to employees and directors is calculated using the Black-Scholes option pricing model, even though the model was developed to estimate the fair value of freely tradable, fully transferable options without vesting restrictions, which differ significantly from the Company's stock options. The Black-Scholes model also requires subjective assumptions, including future stock price volatility and expected time to exercise, which greatly affect the calculated values. The expected term of options granted is derived from historical data on employee exercises and post-vesting employment termination behavior. The risk-free rate selected to value any particular grant is based on the U.S. Treasury rate that corresponds to the term of the grant effective as of the date of the grant. The expected volatility is based on the historical volatility of the Company's stock price. These factors could change in the future, affecting the determination of stock-based compensation expense in future periods.

The weighted-average fair value of stock-based compensation is based on the single option valuation approach. Forfeitures are estimated and it is assumed no dividends will be declared. The estimated fair value of stock-based

Table of Contents

compensation awards to employees is amortized using the straight-line method over the vesting period of the options.

The Company's fair value calculations for stock-based compensation awards to employees under its stock option plans for the three months ended March 31, 2010 and 2009 were based on the following assumptions:

	Three Months Ended	
	March 31, 2010	March 31, 2009
Expected term	5.54 years	6.35 years
Expected volatility	97.56%	104.82 105.51%
Risk-free interest rate	2.53%	1.63 2.03%
Expected dividend yield		

A summary of option activity as of March 31, 2010 and changes during the three months then ended, is presented below (in thousands except per share data):

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Options outstanding at January 1, 2010	3,223	\$0.49		\$
Options granted	45	\$0.33		\$
Options exercised		\$		\$
Options forfeited/canceled	(60)	\$0.57		\$
Options outstanding and expected to vest at March 31, 2010	3,208	\$0.49	6.6	\$286
Options exercisable at March 31, 2010	2,098	\$0.63	5.4	\$107

The aggregate intrinsic value is calculated as the difference between the exercise price of the stock options and the quoted price of the Company's common stock at period end. There were no stock options exercised during the quarter ended March 31, 2010. There were 2,120,634 options outstanding and 1,016,882 exercisable options as of March 31, 2010, that were in-the-money. As of March 31, 2009, there were 717,500 options that were in-the-money with an aggregate intrinsic value of approximately \$76,000.

The weighted average grant date fair value of options granted during the three months ended March 31, 2010 and 2009 was \$0.25 and \$0.11 per option, respectively.

As of March 31, 2010, there was approximately \$126,000, net of forfeitures, of total unrecognized compensation cost related to employee and director stock option compensation arrangements. That cost is expected to be recognized over the weighted average remaining vesting period of approximately 1.6 years. For the three months ended March 31, 2010 and 2009, the amount of stock-based compensation expense related to stock options was approximately \$34,000 and \$32,000, respectively. For the three months ended March 31, 2010 and 2009, the amount of stock-based compensation expense related to ESPP contributions was approximately \$0 and \$12,000, respectively.

On March 31, 2009, the Company granted awards of restricted stock to each of its employees totaling approximately 1,208,000 shares. The shares vest as to 33% of the shares on the first anniversary of the grant date, 33% of the shares on the second anniversary of the grant date and 34% of the shares on the third anniversary of the grant date. In addition, in connection with Paul McCormick's appointment to Executive Chairman, on July 1, 2009,

Mr. McCormick was granted 300,000 shares of restricted stock under the Company's Stock Option Plan. The restrictions on Mr. McCormick's shares of restricted stock will lapse in equal installments upon the first and second anniversaries of the date of grant.

Table of Contents

During the three month period ended March 31, 2010, the Company repurchased and cancelled 125,983 shares of its common stock in connection with the vesting of 315,324 shares of restricted stock. The value of the shares repurchased was approximately \$48,000, based on the closing market price on the measurement date. In lieu of remitting the value of the shares to the holders, the Company used such amount to remit payroll taxes associated with the vested shares. Accordingly, the Company recorded the aggregate original issue price of approximately \$33,000 to equity and the difference of the fair value at vesting and the original issue price of approximately \$15,000 to accumulated deficit. As such amount was not remitted as of March 31, 2010, such amount has been included as non-cash financing activity in the accompanying statement of cash flows

For the three months ended March 31, 2010, the stock based compensation related to the amortization of the related compensation cost of the restricted stock was approximately \$27,000. Since shares of restricted stock are subject to cliff vesting the unvested shares as of March 31, 2010, have been excluded from the issued and outstanding shares and basic loss per share computations. As of March 31, 2010, there was approximately \$195,000 of total unrecognized compensation cost related to restricted stock that is expected to be recognized over the weighted average remaining vesting period of 1.8 years.

The following table summarizes the restricted stock activity for the three months ended March 31, 2010 (in thousands):

	March 31, 2010
Unvested Restricted Stock Outstanding at January 1, 2010	1,256
Granted	
Forfeited	
Vested	(315)
Unvested Restricted Stock Outstanding at March 31, 2010	941

The following table summarizes stock-based compensation expense related to stock options, restricted stock and ESPP purchases for the three months ended March 31, 2010 and 2009 which was allocated as follows (in thousands):

	Three Months Ended	
	March 31, 2010	March 31, 2009
Stock-based compensation expense included in:		
Research and development	\$ 4	\$ 2
Sales and marketing	30	23
General and administrative	27	19
	\$ 61	\$ 44

5. Legal Matters:

As previously reported, CardioFocus, Inc. (CardioFocus) filed a complaint in the United States District Court for the District of Massachusetts (Case No. 1.08-cv-10285) against the Company and a number of other companies. In the complaint, CardioFocus alleges that Cardiogenesis and the other defendants had previously violated patent rights allegedly held by CardioFocus. All of the asserted patents have now expired.

On June 13, 2008, Cardiogenesis filed requests for re-examination of the patents being asserted against Cardiogenesis with the United States Patent and Trademark Office (USPTO) and asserted that prior art had been identified that raised substantial new issues of patentability with respect to the inventions claimed by CardioFocus patents. In August 2008, the USPTO granted Cardiogenesis re-examination requests. Re-examination requests filed by

other named defendants were also granted. The USPTO has now finally concluded and CardioFocus is not appealing the following determinations made in re-examination: (a) all asserted claims of CardioFocus U.S. Patent No. 6,159,203 (the 203 Patent) are unpatentable; (b) 11 of 14 claims of U.S. Patent No. 6,547,780 (the 780 Patent) are unpatentable; and (c) 8 of 13 claims of U.S. Patent No. 5,843,073 (the 073 Patent) are unpatentable.

Table of Contents

However, three claims being asserted by CardioFocus against the Company, namely, Claim 2 of the 780 Patent and Claims 2 and 7 of the 073 Patent have been confirmed by the USPTO.

Based on a motion filed by the defendants, including Cardiogenesis, on October 14, 2008, an Order was issued by the Court staying the present litigation for one (1) year or until the re-examination is completed, which ever occurs sooner. In view of the re-examination having been completed, the Court, at a status conference held on April 22, 2010, lifted the stay that had been imposed and had further scheduled dates in connection with the litigation regarding discovery, law and motion practice, a briefing schedule and hearing for patent claim interpretation proceedings, and other key events. A settlement conference has been scheduled for October 2010 and trial is set to commence on November 7, 2011.

The Company intends to defend itself vigorously in this action. At this time, the Company is unable to predict the outcome of this matter. At this time, the Company is in the opinion that the outcome of this matter will not have a material adverse effect on the Company's financial position, results of operations, or cash flow. However, as this matter is ongoing, there is no assurance that this matter will be resolved favorably by the Company or will not result in a material liability.

Except as described above, the Company is not a party to any material legal proceeding.

6. Related Party Transactions:

The Company entered into a consulting agreement with Mr. McCormick, the Company's Chairman of the Board, effective January 15, 2009. Pursuant to the consulting agreement, Mr. McCormick provided consulting services relating to corporate strategy development and execution, financing and investor relations up to 16 hours per week. In consideration for such services, the Company paid Mr. McCormick \$8,000 per month and reimbursed Mr. McCormick for healthcare insurance coverage up to \$15,600 per year. The consulting agreement had a term of 18 months, but was mutually terminated as of June 30, 2009.

Effective July 1, 2009, the Company entered into an employment agreement with Mr. McCormick whereby he agreed to serve as the Executive Chairman of the Board of Directors and principal executive officer of the Company. Under the terms of the employment agreement, Mr. McCormick is entitled to an annual base salary of \$250,000, provided that he devotes at least 75% of his time to his duties and responsibilities as Executive Chairman under the employment agreement. Mr. McCormick will be entitled to receive certain benefits which will include, at a minimum, medical insurance for Mr. McCormick and his spouse, as well as no less than three weeks paid vacation per year. In addition, Mr. McCormick will also be reimbursed for all reasonable expenses incurred by him in respect of his services to the Company under the employment agreement. The employment agreement has an initial term of one year, which term will be automatically renewed for successive additional one year periods, unless terminated upon 30 days written notice by either Mr. McCormick or the Company. In connection with Mr. McCormick's appointment to Executive Chairman, the Board of Directors granted him 300,000 shares of restricted stock under the Company's Stock Option Plan. The restrictions on Mr. McCormick's shares of restricted stock will lapse in equal installments upon the first and second anniversaries of the date of grant.

Effective July 1, 2009, the Company entered into an amendment to the employment agreement dated as of July 30, 2007 by and between the Company and Richard P. Lanigan, pursuant to which the Company and Mr. Lanigan agreed to the following changes to his employment agreement: (i) Mr. Lanigan's title will be Executive Vice President, Marketing of the Company, (ii) Mr. Lanigan will receive an annual base salary of \$225,000, which represents a decrease of \$22,500 per year, and (iii) Mr. Lanigan will report directly to the Executive Chairman of the Company.

The Company entered into a consulting agreement with Dr. Marvin Slepian, a member of the Company's Board of Directors, dated April 1, 2010 and effective March 24, 2010. Pursuant to the agreement, Dr. Slepian will provide consulting services at the Company's direction relating to basic and clinical scientific initiatives as well as development of certain scientific and educational materials. In consideration for such services, the Company will pay Dr. Slepian \$400 per hour up to a maximum of \$2,500 per day. The agreement may be terminated by either party upon thirty days written notice.

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

Management's Discussion and Analysis of Financial Condition and Results of Operations contains certain statements relating to future results, which are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements are identified by words such as believes, anticipates, expects, intends, plans, will, and similar expressions. In addition, any statements that refer to our plans, expectations, strategies or other characterizations of future events or circumstances are forward-looking statements. These forward-looking statements are based on the beliefs of management, as well as assumptions and estimates based on information available to us as of the dates such assumptions and estimates are made, and are subject to certain risks and uncertainties that could cause actual results to differ materially from historical results or those anticipated, depending on a variety of factors, including those factors discussed in the section titled Risk Factors contained in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2009. Should one or more of those risks or uncertainties materialize adversely, or should underlying assumptions or estimates prove incorrect, actual results may vary materially from those described. Those events and uncertainties are difficult or impossible to predict accurately and many are beyond our control. Except as may be required by applicable law, we assume no obligation to publicly release the result of any revisions that may be made to any forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events. Our business may have changed since the date hereof and we undertake no obligation to update these forward looking statements. The following discussion should be read in conjunction with the unaudited condensed consolidated financial statements and notes thereto included in this Quarterly Report on Form 10-Q.

Overview

We design, develop and distribute laser-based surgical products and disposable fiber-optic accessories for the treatment of cardiac ischemia associated with advanced cardiovascular disease through laser myocardial revascularization. This therapeutic procedure can be performed surgically as transmyocardial revascularization, or TMR. TMR is a laser-based heart treatment in which transmural channels are made in the heart muscle. Many experts believe the mechanism of action for the relief of symptoms is a combination of denervation and angiogenesis.

We have received both FDA approval and a CE mark for our products. Almost all of our revenue is derived from sales of our TMR System in the United States where we began commercial distribution in February 1999. Effective July 1999, the Centers for Medicare and Medicaid Services, or CMS, formerly known as the Health Care Financial Administration, implemented a national coverage decision for Medicare coverage for any TMR procedure as a primary and secondary procedure. As a result, hospitals and physicians are eligible to receive Medicare reimbursement for TMR equipment and procedures on indicated Medicare patients.

We generate the majority of our revenue from sales of our laser consoles and our disposable handpiece units. Due to the current economic slowdown and the reluctance of many customers to make investments in additional capital equipment, sales of our laser consoles have decreased from historic levels. As a result of these and other factors, we refocused our sales strategy in 2009 to emphasize sales of our handpieces, particularly to focus on increasing penetration of accounts with previously installed laser consoles. In combination with the emphasis on sales of handpieces, we have also become more active in conducting and sponsoring professional seminars to educate cardiac surgeons, as well as cardiologists that refer patients to the cardiac surgeon for treatment. Cardiologists are the gatekeepers for patients with cardiac disease and must be updated on the data and clinical benefits of TMR. We believe this refocused strategy will be effective in growing our revenue over the long term.

In addition, we continue our research and development activities in an effort to develop new technologies for the treatment of cardiac ischemia. We submitted an IDE application in December 2009, to begin a U.S. clinical trial for the PHOENIX handpiece a product that combines TMR as tissue stimulation combined with the intramyocardial delivery of biologics or stem cells. We are currently investing resources to support our domestic strategy. We believe that, if the PHOENIX handpiece can ultimately obtain FDA marketing approval it will be the core product to enable us to achieve our desired future growth.

Table of Contents

As of March 31, 2010, we had an accumulated deficit of \$171.1 million. We may continue to incur operating losses. The timing and amounts of our expenditures will depend upon a number of factors, including the efforts required to develop our sales and marketing organization, the timing of market acceptance of our products and the status and timing of regulatory approvals.

Results of Operations

Net Revenues

We generate our revenues primarily through the sale of our laser consoles and handpieces, which are the components of our TMR System, and related services. In addition, we loan our laser consoles to hospitals in accordance with our loaned laser programs. Under certain loaned laser programs we charge the customer an additional amount over the stated list price on our handpieces in exchange for the use of the laser console or we collect an upfront deposit that can be applied towards the purchase of a laser console.

Net revenues of \$3,233,000 for the three months ended March 31, 2010 increased \$381,000, or 13%, when compared to net revenues of \$2,852,000 for the three months ended March 31, 2009. The increase in sales was primarily attributed to an increase in handpiece revenue for the three month period ended March 31, 2010 as compared to the prior year. We refocused our sales strategy in 2009 to emphasize sales of our handpieces, particularly to focus on increasing penetration of accounts with previously installed laser consoles.

For the three months ended March 31, 2010, domestic handpiece revenue increased by \$492,000, or 29%, and domestic laser revenue decreased by \$52,000, or 7%, when compared to the three months ended March 31, 2009. In the first quarter of 2010, domestic handpiece revenue was \$2,190,000, inclusive of \$238,000 in sales of product to customers operating under our loaned laser program. In the first quarter of 2009, domestic handpiece revenue was \$1,699,000, inclusive of \$111,000 in sales of product to customers operating under our loaned laser program.

International sales, accounting for approximately 1% of net revenues for the three months ended March 31, 2010, decreased \$33,000 from the three months ended March 31, 2009. In addition, service and other revenue of \$289,000 decreased \$27,000 for the quarter ended March 31, 2010, when compared to \$316,000 for the quarter ended March 31, 2009.

Gross Margin

Gross profit of 84% of net revenues for the quarter ended March 31, 2010 was higher than 81% of net revenues for the quarter ended March 31, 2009. Gross profit in absolute dollars increased by \$389,000 to \$2