

Conatus Pharmaceuticals Inc.  
Form 10-Q  
November 08, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF  
1934  
FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2016

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF  
1934  
FOR THE TRANSITION PERIOD FROM                      TO

Commission file number: 001-36003

CONATUS PHARMACEUTICALS INC.

(Exact name of registrant as specified in its charter)

Delaware	20-3183915
(State or Other Jurisdiction of	(I.R.S. Employer
Incorporation or Organization)	Identification No.)
16745 W. Bernardo Dr., Suite 200	
San Diego, CA	92127
(Address of Principal Executive Offices)	(Zip Code)

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(858) 376-2600

(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 has submitted electronically and posted on its corporate website, 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 (Do not check if a smaller reporting company) 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 November 1, 2016, the registrant had 26,067,154 shares of common stock (\$0.0001 par value) outstanding.

CONATUS PHARMACEUTICALS INC.

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## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

## Conatus Pharmaceuticals Inc.

## Condensed Balance Sheets

(Unaudited)

	September 30, 2016	December 31, 2015
Assets		
Current assets:		
Cash and cash equivalents	\$ 14,313,617	\$ 13,876,090
Marketable securities	16,750,005	22,632,019
Prepaid and other current assets	1,137,384	1,982,031
Total current assets	32,201,006	38,490,140
Property and equipment, net	285,023	344,734
Other assets	876,130	892,394
Total assets	\$ 33,362,159	\$ 39,727,268
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable and accrued expenses	\$ 2,354,507	\$ 2,545,894
Accrued compensation	1,609,668	1,436,804
Total current liabilities	3,964,175	3,982,698
Note payable	1,000,000	1,000,000
Deferred rent	181,637	204,224
Stockholders' equity:		
Preferred stock, \$0.0001 par value; 10,000,000 shares authorized; no shares		
issued and outstanding	—	—
Common stock, \$0.0001 par value; 200,000,000 shares authorized; 25,179,655 shares		
issued and 25,173,339 shares outstanding, excluding 6,316 shares subject to		
repurchase, at September 30, 2016; 19,877,857 shares issued and 19,845,611 shares		
outstanding, excluding 32,246 shares subject to repurchase, at December 31, 2015	2,517	1,984
Additional paid-in capital	169,713,802	155,441,280
Accumulated other comprehensive income (loss)	8,978	(3,907)

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the officer's annual base compensation in the event the officer's services are terminated without cause or payments of up to two times the officer's annual base compensation including bonuses in connection with a termination of the officer's services within an 18 month period following a change in ownership of Intervoice, as defined in the agreements. If both of these officers are terminated for one of the preceding reasons during fiscal 2009, we will incur costs ranging from \$1.0 million to \$1.3 million. At May 31, 2008, we had seven agreements with senior vice presidents that were effective March 1, 2007, with two year initial terms. In the event of a Corporate Change, as defined in the agreement, for any executive that has less than one year remaining in the employment term, the employment term would automatically be extended to be effective through the date that is one year following the effective date of the Corporate Change. In the event that these agreements were terminated without cause, the executive would be entitled to his or her base salary for a period of 12 months following the termination date. We incurred costs of approximately \$0.4 million during the first quarter of fiscal 2009 as a result of termination of a senior vice president's employment by the Company. Another of such senior vice presidents retired effective May 31, 2008 and no costs were incurred as a result of his termination. If the remaining five senior vice presidents are terminated during fiscal 2009, we will incur costs of approximately \$1.1 million. In addition to the agreements with our senior vice presidents, we have agreements with two other officers that provide for their employment through August 2008. If we terminated these officers prior to the expiration of their contracts, we would owe them the greater of their compensation for the unexpired term of the contracts or one-half of their annual compensation under the contract. If these two other officers are terminated during fiscal 2009, we will incur costs of approximately \$0.2 million.

On July 2, 2008 we and our Chief Executive Officer, Robert Ritchey, entered into a severance agreement (the Severance Agreement) to provide for Mr. Ritchey's retirement from the Company effective August 31, 2008. Under the Severance Agreement, and subject to Mr. Ritchey executing a broad general release in favor of the Company following his retirement, he will receive a lump sum payment of \$592,500, which is equal to 18 months of his base salary, and reimbursement of our portion of his COBRA (or retiree health plan option, if applicable) premiums. The Severance Agreement further provides that the exercise period for certain stock options held by Mr. Ritchey will be extended by up to 18 months and the vesting of certain stock options will be accelerated. We currently anticipate that we will recognize expenses pursuant to Financial Accounting Standard 123R in an amount equal to approximately \$0.3 million as a result of extending and accelerating Mr. Ritchey's stock options. We also agreed to reimburse Mr. Ritchey for legal fees he incurred in negotiating the Severance Agreement in an amount not to exceed \$50,000.

Under the terms of our Articles of Incorporation, we indemnify our directors, officers, employees or agents or any other person serving at our request as a director, officer, employee or agent of another corporation in connection with a derivative suit if he or she (1) is successful on the merits or otherwise or (2) acted in good faith, and in a manner he or she reasonably believed to be in or not opposed to the best interests of the corporation. We will not provide indemnification, however, for any claim as to which the person was adjudged liable for negligence or misconduct unless the court determines that under the circumstances the person is fairly and reasonably entitled to indemnification. We provide the same category of persons with indemnification in a non-derivative suit only if such person (1) is successful on the merits or otherwise or (2) acted in good faith, and in a manner he or she reasonably believed to be in or not opposed to the best interests of the corporation, and with respect to any criminal action or proceeding, had no reason to believe his or her conduct was unlawful. Under the terms of our Bylaws, we also indemnify our current and former officers and directors to the fullest extent permitted or required under Article 2.02-1 of the Texas Business Corporation Act.

In connection with certain lawsuits filed against us and certain of our present and former officers and directors (see Pending Litigation above), we have agreed to pay in advance any expenses, including attorneys' fees, incurred by such present and former officers and directors in defending such litigation, in accordance with Article 2.02-1 of the Texas Business Corporation Act and the Company's Articles of Incorporation and Bylaws. Each of these parties has provided us with a written undertaking to repay us the expenses advanced if the person is ultimately not entitled to indemnification.

Texas corporations are authorized to obtain insurance to protect officers and directors from certain liabilities, including liabilities against which the corporation cannot indemnify its officers and directors. We have obtained liability insurance for our officers and directors as permitted by Article 2.02-1 of the Texas Business Corporation Act.

Our insurance policies provide coverage for losses and expenses incurred by us and our current and former directors and officers in connection with claims made under the federal securities laws. These policies, however, exclude losses and expenses related to the Barrie class action lawsuit, or to other litigation based on claims that are substantially the same as those in the Barrie class action, and contain other customary provisions to limit or exclude coverage for certain losses and expenses.

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

**Critical Accounting Policies.** In preparing our consolidated financial statements in conformity with accounting principles generally accepted in the United States, we use estimates and projections that affect the reported amounts and related disclosures and that may vary from actual results. Our critical accounting policies are discussed fully in the Annual Report on Form 10-K for the year ended February 29, 2008.

**Sales.** We operate as a single, integrated business unit. Our chief operating decision maker assesses performance and allocates resources on an enterprise wide basis. Our product line includes voice portal solutions, messaging solutions, payment solutions, maintenance and related services, and hosted solutions provided for customers on an outsourced or hosted solution provider basis. We believe that product line distinction provides the most meaningful breakdown of quarterly and annual sales activity. Our net sales by product line for the three months ended May 31, 2008 and 2007 were as follows (in thousands):

	Three Months Ended May 31,		
		% Change From Prior Year	
	2008		2007
Voice portal solution sales	\$ 14,771	11.5%	\$ 13,249
Messaging solution sales	7,773	19.1%	6,526
Payment solution sales	1,368	(29.0)%	1,927
Total solution sales	23,912	10.2%	21,702
Maintenance and related services revenues	22,395	5.3%	21,275
Hosted solutions revenues	5,205	9.5%	4,754
Total recurring services revenues	27,600	6.0%	26,029
Total sales	\$ 51,512	7.9%	\$ 47,731

We assign revenues to geographic areas based on the locations of our customers. Our net sales by geographic area for the three months ended May 31, 2008 and 2007 were as follows (in thousands):

	Three Months Ended May 31,		
		% Change From Prior Year	
	2008		2007
North America	\$ 30,834	(1.1)%	\$ 31,164
Europe	10,467	26.9%	8,251
Middle East and Africa	4,817	(2.3)%	4,931
Central and South America	2,942	184.0%	1,036
Pacific Rim	2,452	4.4%	2,349
Total	\$ 51,512	7.9%	\$ 47,731

International sales comprised 40% of our total sales during the first quarter of fiscal 2009, up from 35% during the first quarter of fiscal 2008.

Total sales for the first quarter of fiscal 2009 increased 7.9% as compared to the first quarter of fiscal 2008. Increases in voice portal solution sales and messaging solution sales were offset by decreases in payment solution sales. Voice portal solution sales increased in Europe, Latin America and Middle East and Africa offset by decreased sales in North America and Pacific Rim. Messaging solution sales showed growth in Europe, Pacific Rim and Latin America offset by decreased sales in Middle East and Africa. Payment solution sales continue to primarily reflect sales of capacity upgrades to existing customers.

The increase in our maintenance and related services revenues in the first quarter of fiscal 2009 as compared to the first quarter of fiscal 2008 is comprised of increases of \$0.6 million (3.4%) in maintenance revenues on voice portal solutions and \$0.5 million (34.7%) in maintenance revenues on messaging solutions.

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The increase in maintenance revenue on messaging solutions resulted primarily from revenue recognized on a cash basis from a Latin American customer.

The 9.5% increase in hosted solutions revenue in the first quarter of fiscal 2009 compared to the first quarter of fiscal 2008 resulted primarily from growth in voice portal hosted solution sales in North America. The increase also reflected \$0.4 million and \$0.2 million, respectively, for the quarters ended May 31, 2008 and 2007 related to services performed for an international hosted solutions customer for which we recognize revenue on a cash basis.

One customer, a U.K. based network operator, provided approximately 10% of our revenue for the quarter ended May 31, 2008. No customer accounted for 10% or more of our revenue during the quarter ended May 31, 2007.

We are prone to quarterly sales fluctuations. Some of our transactions are completed in the same fiscal quarter as ordered. The quantity and size of large sales (sales valued at approximately \$1.0 million or more) during any quarter can cause wide variations in our quarterly sales and earnings, as such sales may be unevenly distributed throughout the fiscal year. We use a system combining estimated sales from our recurring services contracts, our backlog of committed solutions orders and our pipeline of solutions sales opportunities to estimate sales and trends in our business. For the quarters ended May 31, 2008 and 2007, sales were sourced as follows:

	Three Months Ended May 31,	
	2008	2007
Sales from recurring services and support contracts, including contracts for hosted solutions	53%	55%
Sales from beginning solutions backlog	38%	33%
Sales from the quarter's pipeline	9%	12%
	100%	100%

Our service and support contracts range in original duration from one month to five years, with most hosted solutions contracts having initial terms of two to three years and most maintenance and related contracts having initial terms of one year. Because many of the contracts give customers early cancellation privileges, we do not consider our book of services contracts to be reportable backlog, as a portion of the potential revenue reflected in the contract values may never be realized if customers elect to cancel, notwithstanding that many of our hosted solutions contracts contain provisions that provide for early termination fees to be paid by the customer if they cancel. Nevertheless, it is easier for us to estimate service and support revenues than to estimate solutions sales for the next quarter because the service and support contracts generally span multiple quarters and revenues recognized under each contract are generally similar from one quarter to the next.

Our backlog is made up of customer orders for solutions for which we have received complete purchase orders. Backlog as of the end of our last five fiscal quarters was as follows (in thousands):

Quarter Ended	Backlog
May 31, 2008	\$61,979
February 29, 2008	\$65,741
November 30, 2007	\$55,862
August 31, 2007	\$64,463
May 31, 2007	\$60,411

We generally expect all projects in our existing backlog to be initiated within the next twelve months and most of such backlog to be recognized as revenue within twelve months. However, some of our larger, more complex projects, particularly network projects, may extend for longer periods. Approximately 10% of such backlog could convert to revenue subsequent to twelve months. The accuracy of any estimate of future sales is dependent, in part, on our ability to project the amount of revenue to be contributed from beginning solutions backlog during any fiscal quarter. Our ability to estimate the amount of backlog that will be converted to revenue in any fiscal quarter can be affected by

factors outside our control, including changes in project timing requested by our customers and cash collections from certain international customers. Approximately 16% of our solutions backlog at May 31, 2008 relates to customers for which revenue is recognized on a cash basis which impacts the time between project completion and revenue recognition.

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Our pipeline of opportunities for solutions sales is the aggregation of our sales opportunities for which we have not received a purchase order, with each opportunity evaluated for the date the potential customer will make a purchase decision, competitive risks, and the potential amount of any resulting sale. No matter how promising a pipeline opportunity may appear, there is no assurance it will ever result in a sale. Accordingly, upward or downward trends in our total pipeline are not considered meaningful from a financial analysis perspective. While we incorporate an estimate of sales from pipeline into our business planning and budgeting, pipeline estimates are necessarily speculative and may not consistently correlate to solutions sales in a particular quarter or over a longer period of time. While we know the amount of solutions backlog available at the beginning of a quarter, we must speculate on our pipeline of solutions opportunities for the quarter. Our accuracy in estimating total solutions sales for the next fiscal quarter is, therefore, highly dependent upon our ability to successfully estimate which pipeline opportunities will close during the quarter.

**Cost of Goods Sold.** Cost of goods sold was comprised of the following for the quarters ended May 31, 2008 and 2007 (in thousands):

	Three Months Ended May 31,	
	2008	2007
Solutions COGS	\$15,632	\$15,182
As percentage of solutions sales	65.4%	70.0%
Services COGS	7,904	\$ 7,291
As percentage of services revenues	28.6%	28.0%
Total COGS	23,536	\$22,473
As percentage of total sales	45.7%	47.1%

The decrease in solutions cost of goods sold as a percentage of solutions sales in the first quarter of fiscal 2009 as compared to the first quarter of fiscal 2008 reflected work performed during the first quarter of fiscal 2008 on the \$10.3 million media exchange contract entered into in February 2007. We realized no net margin on approximately \$3.3 million of revenue recognized under this contract and provided an additional loss provision of approximately \$0.2 million during the first quarter of fiscal 2008 as compared to \$0.6 million of revenue recognized under this contract during the first quarter of fiscal 2009.

**Research and Development Expenses.** Research and development expenses for the quarters ended May 31, 2008 and 2007 were as follows (in thousands):

	Three Months Ended May 31,	
	2008	2007
Research and development expenses	\$4,757	\$5,317
As percentage of total sales	9.2%	11.1%

Research and development expenses are lower during the first quarter of fiscal 2009 as compared to the first quarter of fiscal 2008 as a result of approximately \$0.5 million of severance and organizational changes which occurred in fiscal 2008 but were not repeated in fiscal 2009. The decrease also reflects reductions in salaries, contract labor, insurance and depreciation. These reductions are offset, in part, by a reduction of approximately \$0.8 million of development effort related to the large media exchange contract which was reflected in cost of goods sold rather than research and development expenses. Research and development expenses include the design of new products and the enhancement of existing products.

Our research and development spending is focused in six key areas. First, we are developing software tools to aid in the development and deployment of customer applications incorporating speech recognition, text-to-speech, and other rich media technologies for enterprises and wireless and wireline providers. Next, we are developing server-based application software platforms for operations and management of contact center, speech and call completion applications. We will use these software platforms for deployment and management of enterprise, wireless

and wireline network operator applications. Third, we are developing media servers, voice browsers, and call processing infrastructure based on open standards such as VoiceXML, CCXML and SCXML. These media servers are VoIP enabled, allowing operation in soft-switch and hybrid PSTN and VoIP networks. Fourth, we are developing packaged applications for the network operator and enterprise markets. These include vertical and horizontal applications that are designed to greatly enhance customer return-on-investment by providing many commonly used configurable functions that can be

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deployed more quickly than custom applications. Fifth, we are developing software and tools designed to provide integration of live agent positions in a customer contact center setting. This software covers a broad range of functions including agent call-screen transfer, workflow management, full call recording, agent and supervisor management systems and reporting and various integration functions. Finally, we are developing modular productivity and communications applications for wireless applications including voice mail, call completion applications and other enhanced service offerings.

We expect to maintain a strong commitment to research and development so that we can remain at the forefront of technology development in our markets.

**Selling, General and Administrative Expenses.** Selling, general and administrative expenses for the quarters ended May 31, 2008 and 2007 were as follows (in thousands):

	Three Months Ended May 31,	
	2008	2007
Selling, general and administrative expenses	\$18,889	\$20,693
As percentage of total sales	36.7%	43.4%

Selling, general and administrative expenses for the first quarter of fiscal 2009 decreased from fiscal 2008 levels. This decrease includes reductions in contract labor, insurance and legal and accounting fees resulting from various cost control initiatives as well as a refund of previously expensed sales and use taxes.

**Amortization of Acquired Intangible Assets.** We incurred expenses of approximately \$0.6 million related to the amortization of acquisition related intangibles in the first quarter of fiscal 2009. Such amortization related to intangible assets acquired in the purchase of certain assets from Nuasis, the acquisition of Edify and the merger with Brite Voice Systems.

**Income Taxes.** For the three months ended May 31, 2008, our quarterly effective tax rate of 26% varies from the U.S. federal statutory rate primarily due to certain non-deductible expenditures, a decrease in the valuation allowance associated with the net operating loss carryforward related to the Texas Margin Tax and the reduction of a German tax liability associated with the lower German corporate income tax rate. Our deferred tax assets related to other state net operating loss carryforwards remain fully reserved due to uncertainty of utilization of those assets.

For the three months ended May 31, 2007, our quarterly effective tax rate of 13% varies from the U.S. federal statutory rate primarily due to certain non-deductible expenditures, an increase in the valuation allowance associated with our U.K. deferred tax assets and the effect of non-U.S. income tax rates. Our U.K. deferred tax assets remained fully reserved; accordingly, we did not recognize the tax benefit associated with our first quarter U.K. loss.

**Income/Loss from Operations and Net Income/Loss.** We generated income from operations of \$3.7 million and net income of \$3.0 million during the first quarter of fiscal 2009. We generated an operating loss of \$1.4 million and a net loss of \$0.9 million during the first quarter of fiscal 2008.

**Liquidity and Capital Resources.** We had approximately \$52.7 million in cash and cash equivalents at May 31, 2008. Our cash reserves increased \$14.0 million during the three months ended May 31, 2008, with operating activities providing \$14.6 million of cash, net investing activities using \$1.5 million of cash and net financing activities providing \$0.7 million of cash.

Operating cash flow for the quarter ended May 31, 2008 resulted from our continuing focus on balance sheet management and collections related to annual maintenance renewals. We improved our days sales outstanding of accounts receivable to 60 days, down slightly from 63 days at February 29, 2008. In addition, deferred revenue increased \$5.4 million due to the timing of annual maintenance contract renewals, which are paid in advance.

For sales of certain of our more complex, customized systems, we recognize revenue based on a percentage of completion methodology. Unbilled receivables accrued under this methodology totaled \$13.9 million (40.5% of total net receivables) at May 31, 2008, up \$5.5 million from February 29, 2008 primarily as a result of the timing of billing milestones on several large projects.

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While we continue to focus on the level of our investment in accounts receivable, we generate a significant percentage of our sales, particularly sales of enhanced telecommunications services systems, outside the United States. Customers in certain countries are subject to significant economic and political challenges that affect their cash flow, and many customers outside the United States are generally accustomed to vendor financing in the form of extended payment terms. To remain competitive in markets outside the United States, we may offer selected customers such payment terms. In all cases, however, we only recognize revenue at such time as our system or service fee is fixed or determinable, collectibility is probable and all other criteria for revenue recognition have been met. In some limited cases, this policy may result in recognizing revenue on a cash basis, limiting revenue recognition on certain sales of systems and/or services to the actual cash received to date from the customer, provided that all other revenue recognition criteria have been satisfied.

We used \$1.5 million of cash on investing activities during the first quarter of fiscal 2009. Of this amount, we used \$0.2 million for costs in connection with our SAP implementation, \$0.6 million to purchase equipment to expand our hosted solutions business and \$0.7 million for replacement and expansion of our computing infrastructure and other capital purchases.

During the quarter ended May 31, 2008, our financing activities provided \$0.7 million in net cash flow. Our option holders exercised options for approximately 0.2 million shares of common stock and, in so doing, provided us with \$0.7 million in cash.

### **Adequacy of Cash Reserves**

We believe our cash reserves and internally generated cash flow will be sufficient to meet our cash requirements for at least the next twelve months.

### **Impact of Inflation**

We do not expect any significant short-term impact of inflation on our financial condition. We presently are not bound by long-term fixed price sales contracts. The absence of such contracts reduces our exposure to inflationary effects.

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

**Evaluation of disclosure controls and procedures.** Our disclosure controls and procedures are designed to provide reasonable, but not absolute, assurance that the objectives of our disclosure control system are met. A control system, no matter how well conceived and operated, is subject to inherent limitations. These limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple errors or mistakes. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more persons or by management override of the control. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

Based on the evaluation by our management (with the participation of our Chief Executive Officer and Chief Financial Officer), as of the end of the period covered by this report, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) are effective to provide reasonable assurance that material information required to be disclosed by us in reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC rules and forms. Such officers also have concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed in the reports we file or submit under the Exchange Act is accumulated and communicated to our management, including our principal executive and principal financial officers, to allow timely decisions regarding required disclosure.

**Changes in internal control.** There has been no change in our internal control over financial reporting identified in connection with the evaluation that occurred during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

See Pending Litigation in Note I in Item 1 of Part I of this quarterly report on Form 10-Q.

**Item 1A. Risk Factors**

This report on Form 10-Q includes 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. All statements other than statements of historical facts included in this Form 10-Q, including, without limitation, statements contained in Management's Discussion and Analysis of Financial Condition and Results of Operations and Notes to Consolidated Financial Statements located elsewhere in this report regarding our financial position, business strategy, plans and objectives of management for future operations, future sales and industry conditions, are forward-looking statements. Although we believe that the expectations reflected in such forward-looking statements are reasonable, we can give no assurance that such expectations will prove to be correct. In addition to important factors described elsewhere in this report, we caution current and potential investors that the following important risk factors, among others, sometimes have affected, and in the future could affect, our actual results and could cause such results during fiscal 2009, and beyond, to differ materially from those expressed in any forward-looking statements made by or on behalf of Intervoice:

*Our operating results may fluctuate significantly from period to period, and this may cause our stock price to decline.* Our revenue and operating results have fluctuated in the past and we expect further fluctuations in the future. Given these fluctuations, we believe that quarter to quarter comparisons of our revenue and operating results are not necessarily meaningful or an accurate indicator of our future performance. As a result, our results of operations may not meet the expectations of securities analysts or investors in the future, which could cause our stock price to decline. Factors that contribute to fluctuations in our operating results and can preclude our ability to accurately forecast our results include the following:

variability in the time periods necessary to complete projects and achieve project milestones in order to recognize revenue, which may be influenced by volume, size, timing, contractual terms for new sales orders and cash basis revenues;

the components of our revenue that are deferred, including our subscription-based hosted solutions and that portion of our sales revenue attributable to support and maintenance;

volume, timing and fulfillment of customer orders, particularly with respect to large orders (sales of approximately \$1.0 million or more), some of which are completed in the same quarter in which they are ordered and some of which are completed over several quarters, and fluctuations in demand for our products and services;

our ability to complete orders from our solutions backlog, subject to timing changes requested by our customers, and projects accounted for on a percentage of completion basis, including estimates based on a variety of factors and subject to revision;

our ability to convert our pipeline of opportunities into sales;

the use of low pricing to win important customers, and the possible recognition of loss contingencies for certain projects that we estimate will be delivered at a negative gross margin;

the lengthy sales cycle for our products, which typically involve comprehensive solutions that may require detailed customer evaluations;

the performance of our international business, which accounts for a significant portion of our consolidated revenues, and fluctuations in foreign currency exchange rates;

the mix of products we sell and services we offer and whether our products are sold through our direct sales force or through an intermediary;

introduction of new products, product upgrades or updates by us or our competitors, and any resulting customer delays in purchasing products;

any increased price sensitivity by our customers, particularly due to increased competition including open source or free software;

periodic difficult economic conditions, particularly affecting the technology industry, as well as economic uncertainties;

higher than anticipated costs related to fixed-price contracts with our customers;

our ability to effectively manage our operating expense levels;

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timing of significant marketing and sales promotions, and expenses incurred pursuing new product or market opportunities;

stock-based compensation expense, which we began recognizing for our stock-based compensation plans in the first quarter of fiscal 2007;

costs and charges related to certain events, including Sarbanes-Oxley compliance efforts, matters relating to our litigation and other potential loss contingencies;

the structure, timing and integration of acquisitions of businesses, products and technologies and related disruption of our current business;

factors that lead to substantial declines in estimated values of long-lived assets below their carrying value; and

changes in generally accepted accounting principles.

Due to these and other factors, our revenue and operating results are difficult to forecast and are prone to fluctuate, which may cause a decline in our stock price. Our expense levels are based in significant part on our expectations of future revenue, and we may not be able to reduce our expenses quickly to respond to a shortfall in projected revenue, or a change in the product and geographic sales mix underlying such revenue, or an increase in expenses due to a change in our sales mix. Therefore, our failure to meet revenue and profitability expectations could seriously harm our business, operating results and financial condition. See the discussion entitled *Sales* in Item 2 of Part I for a discussion of our system for estimating sales and tracking sales trends in our business.

*Our stock price has been and may continue to be subject to wide fluctuations.* Our stock price historically has been volatile and may continue to be volatile in the future. Various factors contribute to the volatility of our stock price, including business developments (such as new product introductions and acquisitions or dispositions), litigation developments, quarterly variations in our financial results, our ability to meet investors' expectations, and general economic and market conditions. In addition, third-party announcements by our partners and competitors may contribute to our stock price volatility. Certain types of investors may choose not to invest in stocks with this level of stock price volatility. Fluctuations in our stock price could cause increased risk of shareholder litigation, which could result in substantial costs and divert management's attention and resources.

*We are subject to potential and pending lawsuits and other claims.* We are subject to certain potential and pending lawsuits and other claims discussed in Note I in Item 1 of Part I of this quarterly report on Form 10-Q. Furthermore, we may become subject to additional claims. Any adverse judgment, penalty or settlement related to any lawsuit or other such claim could have consequences that would be material to our financial position or results of operations. We may be required to indemnify certain of our current and former directors and officers under existing arrangements in connection with the defense, or advancement of defense-related expenses we are currently providing to certain individuals in connection with the class action lawsuit. Our insurance policies provide coverage for certain losses and expenses incurred by us and our current and former directors and officers in connection with claims made under the federal securities laws. These policies, however, exclude losses and expenses related to the Barrie class action lawsuit discussed in Note I or to other litigation based on claims that are substantially the same as the claims in the Barrie class action and contain other customary provisions to limit or exclude coverage for certain losses and expenses.

*We face intense competition based on product capabilities and we experience ever increasing demands from our actual and prospective customers for our products to be compatible with a variety of rapidly proliferating computing, telephony and computer networking technologies and standards.* Our success is dependent, to a large degree, on our effectiveness in allocating resources to developing and improving products compatible with those technologies, standards and functionalities that ultimately become widely accepted by our current and prospective

customers. Our success is also dependent, to a large degree, on our ability to implement arrangements with vendors of complementary product offerings so that we can provide our current and prospective customers greater functionality. Our principal competitors include Avaya, Cisco, Nortel, Nuance Communications, Converse Technology, Unisys and Alcatel-Lucent. Many of our competitors have greater financial, technological and marketing resources than we have, as well as greater name recognition. Although we have committed substantial resources to enhance our existing products and to develop and market new products, there is no assurance we will be successful. In addition, it is possible that new entrants to the market and strategic acquisitions and partnerships between existing companies could increase

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the competition in the markets in which we participate. An increase in such competition could materially adversely affect our ability to sell our products, thereby adversely affecting our business, operating results and financial condition.

*We may not be successful in selling and implementing our products and services in the face of the new, standards-based market.* Intervoice has historically provided complete, bundled hardware and software solutions using internally developed components to address our customers' total business needs. The markets for our products have required a shift to the development of products and services based on an open, standards-based architecture utilizing VoiceXML standards. Such an open, standards-based approach allows customers to independently purchase and combine hardware components, standardized software modules, and customization, installation and integration services from individual vendors deemed to offer the best value in the particular class of product or service. The standards-based approach has and will continue to foster increased competition, including competition based on price resulting in increased pressure on gross margins. In such an environment, we believe we may sell less hardware and fewer bundled systems and may become increasingly dependent on our development and sale of software application packages, customized software and consulting and integration services. This shift places new challenges on us to hire and retain the mix of personnel necessary to respond to this business environment, to adapt to the changing expense structure that the new environment may tend to foster, to respond to potentially different competitors, and to increase sales of services, customized software and application packages to offset reduced sales of hardware and bundled solutions. Failure to develop, enhance, acquire and introduce new products and services to respond to continually changing market conditions or customer requirements, or lack of customer acceptance of our products or services, will materially adversely affect the value of our intellectual property, barriers to entry to our business, customer retention, gross margins, and the results of operations and financial condition.

*We may not be able to retain our customer base, and, in particular, our more significant customers.* Our success is heavily dependent on our ability to retain our significant customers. The loss of one of our significant customers could negatively impact our operating results. Our installed base of customers generally is not contractually obligated to place further solutions orders with us or to extend their services contracts with us at the expiration of their current contracts.

*We will be harmed if we lose key business and technical personnel.* We rely upon the services of a relatively small number of key technical, project management and senior management personnel, most of whom do not have employment contracts. If we were to lose any of our key personnel, replacing them could be difficult and costly. If we were unable to successfully and promptly replace such personnel, our business could be materially harmed.

*Our reliance on significant vendor relationships could result in significant expense or an inability to serve our customers if we lose these relationships.* Although we generally use standard parts and components in our products, some of our hardware components are available only from a small number of vendors. Likewise, we license speech recognition technology primarily from Nuance Communications, Inc., the dominant vendor for this technology. As we continue to migrate to open, standards-based systems, we will become increasingly dependent on our component suppliers and software vendors. To date, we have been able to obtain adequate supplies of needed components and licenses in a timely manner, and we expect to continue to be able to do so. Nevertheless, if our significant vendors are unable to supply components or licenses at current levels, we may not be able to obtain these items from another source or at historical prices. In such instances, we would be unable to provide products and services to our customers or generate historical operating margins, and our business and operating results would suffer.

*If third parties assert claims that our products or services infringe on their technology and related intellectual property rights, whether the claims are made directly against us or against our customers, we could incur substantial costs.* We believe software and technology companies, including us and others in our industry, increasingly may become subject to infringement claims. Such claims may require us to enter into costly license agreements or result in even more costly litigation. To the extent a licensing arrangement is required, the

arrangement may not be available at all, or, if available, may be very expensive or even prohibitively expensive. As with any legal proceeding, there is no guarantee we will prevail in any litigation instituted against us asserting infringement of intellectual property rights. To the extent we suffer an adverse judgment, we might have to pay substantial damages, discontinue the use and sale of infringing products, repurchase infringing products from our customers in

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accordance with indemnity obligations, expend significant resources to acquire non-infringing alternatives, and/or obtain licenses to the intellectual property that has been infringed upon. As with licensing arrangements, non-infringing substitute technologies may not be available and, if available, may be very expensive, or even prohibitively expensive, to implement. Accordingly, for all of the foregoing reasons, a claim of infringement could ultimately have a material adverse effect on our business, financial condition and results of operations.

*We are exposed to risks related to our international operations that could increase our costs and hurt our business.* Our products are currently sold in more than 80 countries. Our international sales were 40% and 35% of total sales for the fiscal quarters ended May 31, 2008 and May 31, 2007, respectively. International sales, personnel and property are subject to certain risks, including:

terrorism;

fluctuations in currency exchange rates;

ability to collect on accounts receivable;

the difficulty and expense of maintaining foreign offices and distribution channels;

tariffs and other barriers to trade;

greater difficulty in protecting and enforcing intellectual property rights;

general economic and political conditions in each country, including nationalization of customers or channel partners;

loss of revenue, property and equipment from expropriation;

import and export licensing requirements; and

additional expenses and risks inherent in conducting operations in geographically distant locations, including risks arising from differences in language and cultural approaches to the conduct of business.

*Our inability to meet contracted performance targets could subject us to significant penalties.* Many of our contracts, particularly for hosted solutions, foreign contracts and contracts with telecommunication companies, include provisions for the assessment of damages for delayed project completion and/or for our failure to achieve certain minimum service levels. We have had to pay damages in the past and may have to pay additional damages in the future. Any such future damages could be significant.

*Increasing consolidation in the telecommunications and financial industries could adversely affect our revenues and profitability.* The majority of our largest customers are in the telecommunications and financial industries. These industries are undergoing significant consolidation as a result of merger and acquisition activity. This activity could result in a decrease in the number of customers purchasing our products and/or in delayed purchases of our products by customers that are reviewing their strategic alternatives in light of a pending merger or acquisition. If these results occur, our revenues and profitability could decline.

*Our products are complex, and software defects could reduce our revenues and expose us to litigation.* The software products we offer are complex and may contain errors or defects, even after extensive testing and quality control, particularly in early versions. Furthermore, because our products increasingly are designed around an open standards-based architecture incorporating elements developed by third parties, such errors or defects may be outside of our direct ability to control or correct. Any defects or errors could potentially result in loss of revenues, product returns or order cancellations, liquidated damages or other claims for damages and could potentially hinder

market acceptance of our products and harm our reputation. Accordingly, any defects or errors could have a material adverse effect on our business, results of operations and financial condition. Our customer agreements typically contain provisions to limit our product warranty obligations and exposure to potential liability claims.

*We have grown, and may continue to grow, through acquisitions, which could dilute our existing shareholders and could involve substantial acquisition risks.* As part of our business strategy, we have in the past acquired, and expect to continue to acquire or make investments in, other businesses and technologies. We may issue equity securities for future acquisitions, which would dilute our existing shareholders, and we may incur debt in connection with future acquisitions, which may include covenants or other restrictions that hinder our ability to operate our business. Furthermore, our prior acquisitions required substantial integration and management efforts. Acquisitions can involve a number of risks, including:

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difficulty in transitioning and integrating the operations, facilities and personnel of the acquired businesses, including different and complex order processing, support and accounting and financial reporting systems;

loss of key management, sales, research and development and other key employees of the acquired company;

difficulty in integrating acquired products into our product portfolio, including engineering, sales and marketing integration;

impairment of relationships with partners, suppliers and customers;

difficulty in implementing and standardizing company-wide financial, accounting, billing, information and other systems and the internal controls surrounding those systems and processes;

disruption of our ongoing operations and distraction of management and other employees;

difficulty in incorporating acquired technology and rights into our products and technology;

unanticipated expenses and delays in completing acquired development projects and technology integration;

difficulty in management of geographically remote operations in the United States and internationally;

delay of sales to customers pending resolution of product integration between our existing and our newly acquired products; and

difficulty entering new markets or businesses in which we have limited experience.

As a result of these and other risks, we may not realize anticipated benefits from our acquisitions. Any failure to achieve these benefits or failure to successfully integrate acquired businesses and technologies could result in a material adverse affect on our business, results of operations and financial condition.

*We are exposed to risks related to our channel program that could decrease our revenues and hurt our business.* A significant amount of our sales are made through intermediaries such as distributors, system integrators and other strategic channel partners. We endeavor to increase the percentage of sales through intermediaries as we continue to focus our sales efforts through our channel and other partners. We anticipate future revenue growth to depend in large part on our success in expanding relationships, and establishing new relationships, with intermediaries. These intermediaries may sell their own products or other vendors' products that compete with our products, and may compete with our own direct sales force in certain sales opportunities. While we have instituted programs designed to increase sales of our products through intermediaries, certain intermediaries may give greater priority to products of other suppliers, including competitors. Our ability to grow sales through intermediaries depends on our investment in appropriate financial incentives, support and sales tools for intermediaries, while effectively alleviating conflict with our own sales force. Failure to effect this strategy appropriately may result in certain intermediaries choosing to cease or reduce the sales of our products, resulting in a material adverse change in our business, results of operations and financial condition.

*Unanticipated changes in our effective tax rates or exposure to additional income tax liabilities could affect our profitability or increase our loss.* We are a U.S.-based multinational company subject to tax in multiple U.S. and foreign tax jurisdictions. We are generally required to account for taxes in each jurisdiction in which we operate, including making assumptions, interpretations and judgments with respect to the applicable tax requirements. Our provision for income taxes is calculated based on a mix of earnings, statutory rates, and enacted tax rules by jurisdiction, including transfer pricing. Significant judgment is required in determining our provision for income taxes and in evaluating our tax positions on a worldwide basis. It is possible that these positions may be challenged which may have a significant impact on our effective tax rate, which could affect our results of operations and

financial condition.

*Failure to maintain effective internal controls could have a material adverse effect on our business, results of operations, financial condition, and our stock price.* A failure to maintain adequate internal control procedures as required by Section 404 of the Sarbanes-Oxley Act of 2002 may preclude our management's ability to conclude that we have effective internal controls over our financial reporting. These internal controls are also required for us to produce management financial information, make determinations on revenue recognition and other material accounting issues, and prevent financial fraud. If we are unable to produce reliable financial reports, make appropriate determinations on revenue recognition and material accounting policies or prevent fraud, our business, operating results and financial condition could be adversely affected.

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*We have sustained operating losses in the past, and may incur additional losses in the future which may require us to raise additional capital on unfavorable terms. We cannot be certain that our revenue will grow or that we will achieve or maintain profitable operations in the future. If we are unable to maintain profitability, the market price for our stock may decline, perhaps substantially. If we have significant operating losses, we may be required to raise additional capital to maintain or grow our operations. Such additional capital may only be available at unfavorable terms that could be dilutive to existing shareholders, have a high interest rate, contain restrictive covenants, or contain other unfavorable terms.*

**Item 6. Exhibits**

(a) Exhibits

- 3.1 Articles of Incorporation, as amended, of Registrant. (1)
- 3.2 Amendment to Articles of Incorporation of Registrant. (2)
- 3.3 Amendment to Articles of Incorporation of Registrant. (3)
- 3.4 Fourth Amended and Restated Bylaws of Registrant. (4)
- 4.1 Third Amended and Restated Rights Agreement dated as of May 1, 2001 between the Registrant and Computershare Investor Services, LLC, as Rights Agent. (5)
- 4.2 Registration Rights Agreement, dated as of May 29, 2002, between the Registrant and each of the Buyers under a Securities Purchase Agreement. (6)
- 4.3 First Amendment to Third Amended and Restated Rights Agreement dated as of May 29, 2002, between Registrant and Computershare Investor Services, LLC, as Rights Agent. (6)
- 10.1 Second Amendment to Employment Agreement dated December 1, 2004 between Registrant and Robert E. Ritchey. (7)
- 10.2 Separation Agreement dated as of May 16, 2008 between Registrant and Charles E. McDonald. (8)
- 10.3 Intervice, Inc. Fiscal Year 2009 Annual Incentive Compensation Plan. (9)
- 10.4 Second Amendment to Employment Agreement dated March 1, 2007 between Registrant and Michael J. Polcyn. (9)
- 10.5 Fiscal Year 2009 Sales Incentive Plan. (10)
- 31.1 Certification of Chief Executive Officer of Periodic Report Pursuant to Rule 13a-14(a) or Rule 15d-14(a). (10)
- 31.2 Certification of Chief Financial Officer of Periodic Report Pursuant to Rule 13a-14(a) or Rule 15d-14(a). (10)
- 32.1 Certification of Chief Executive Officer of Periodic Report Pursuant to Rule 13a-14(b) and 18 U.S.C. Section 1350. (10)\*
- 32.2 Certification of Chief Financial Officer of Periodic Report Pursuant to Rule 13a-14(b) and 18 U.S.C. Section 1350. (10)\*

- (1) Incorporated by reference to exhibits to the Company's 1995 Annual Report on Form 10-K for the fiscal year ended February 28, 1995, filed with the SEC on May 30, 1995.

- (2)

Incorporated by reference to exhibits to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended August 31, 1999, filed with the SEC on October 14, 1999.

(3) Incorporated by reference to exhibits to the Company's Quarterly Report on Form 10-Q for the quarter ended August 31, 2002, filed with the SEC on October 15, 2002.

(4) Incorporated by reference to exhibits to the Company's Current Report on Form 8-K, filed with the SEC on October 19, 2007.

(5) Incorporated by reference to exhibits to Form 8-A/A (Amendment 3) filed with the SEC on May 9, 2001.

(6) Incorporated by reference to

exhibits to the  
Company's  
Current Report  
on Form 8-K,  
filed with the  
SEC on May 30,  
2002.

- (7) Incorporated by  
reference to  
exhibits to the  
Company's  
Current Report  
on Form 8-K,  
filed with the  
SEC on  
March 3, 2008.
- (8) Incorporated by  
reference to  
exhibits to the  
Company's  
Current Report  
on Form 8-K,  
filed with the  
SEC on May 21,  
2008.
- (9) Incorporated by  
reference to  
exhibits to the  
Company's  
Current Report  
on Form 8-K,  
filed with the  
SEC on June 3,  
2008.
- (10) Filed herewith.

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\* The  
certifications  
attached as  
Exhibit 32.1 and  
32.2 accompany  
the Quarterly  
Report on Form  
10-Q pursuant  
to Section 906  
of the  
Sarbanes-Oxley  
Act of 2002 and  
shall not be  
deemed filed by  
the Company  
for purposes of  
Section 18 of  
the Securities  
Exchange Act of  
1934, as  
amended.

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**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.

INTERVOICE, INC.

Date: July 10, 2008

By: /s/ CRAIG E. HOLMES  
Craig E. Holmes  
Executive Vice President and  
Chief Financial Officer

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**Index to Exhibits**

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