

LITHIUM TECHNOLOGY CORP  
Form 10QSB  
June 01, 2005

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

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**FORM 10-QSB**

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(Mark One)

**QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.**

For the Quarterly Period ended March 31, 2005

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 1-10446

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**LITHIUM TECHNOLOGY CORPORATION**

(Name of Small Business Issuer in Its Charter)

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**DELAWARE**  
(State or Other Jurisdiction of  
Incorporation or Organization)

**13-3411148**  
(I.R.S. Employer  
Identification No.)

**5115 CAMPUS DRIVE, PLYMOUTH MEETING, PENNSYLVANIA 19462**

(Address of Principal Executive Offices) (Zip Code)

**(610) 940-6090**

(Issuer's Telephone Number, Including Area Code)

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APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PAST FIVE YEARS

Check whether the issuer has filed all documents and reports required to be filed by Section 12, 13 or 15(d) of the Exchange Act after the distribution of securities under a plan confirmed by a court. Yes  No

APPLICABLE ONLY TO CORPORATE ISSUERS

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: As of May 24, 2005, 101,978,364 shares of common stock.

Transitional Small Business Disclosure Format (check one): Yes  No

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**EXPLANATORY NOTE**

This document includes a restatement of our consolidated financial statements for the quarter ended March 31, 2004. The restatements were necessary to conform with accounting principles generally accepted in the United States of America ( GAAP ) and reflect the correction of the accounting for the variable conversion feature on the Company s 10% Convertible Debentures. The conversion feature on the 10% Convertible Debentures has been determined to be an embedded derivative under SFAS 133, which is required to be reflected as a liability at fair value. The 10% Convertible Debentures were previously reflected as containing a beneficial conversion feature under EITF 98-5. The adjustments relate solely to the accounting treatment of these transactions and do not affect the Company s historical cash flow.

This Report on Form 10-QSB for the quarter ended March 31, 2005, reflects corrections and restatements of the following financial statements: (a) condensed consolidated statements of operations and comprehensive loss for the quarter ended March 31, 2004; and (b) condensed consolidated statements of cash flows for the quarter ended March 31, 2004. For a more detailed description of the restatements and reclassifications, see Note 3 Restatement of 2004 Quarterly Results to the accompanying notes to the condensed consolidated financial statements contained in this Report on Form 10-QSB. This Report on Form 10-QSB restates certain financial information for the applicable periods set forth in Item 1 Financial Statements and Item 2 Management s Discussion and Analysis of Financial Condition and Results of Operations . The financial statements and related financial information for the affected period contained in our prior Reports on Form 10-QSB for the quarters ended March 31, 2004, June 30, 2004 and September 30, 2004 should not longer be relied upon. We will amend our Reports on Form 10-QSB for fiscal quarters ended June 30, 2004 and September 30, 2004.

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LITHIUM TECHNOLOGY CORPORATION AND SUBSIDIARIES

FORM 10-QSB

FOR THE QUARTER ENDED MARCH 31, 2005

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## PART I FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

## LITHIUM TECHNOLOGY CORPORATION AND SUBSIDIARIES

## (DEVELOPMENT STAGE COMPANIES)

## CONDENSED CONSOLIDATED BALANCE SHEETS

	March 31, 2005	December 31, 2004
	(Unaudited)	
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 1,711,000	\$ 240,000
Accounts receivable	74,000	121,000
Inventories	103,000	141,000
Related party receivable	7,000	187,000
Prepaid expenses and other current assets	610,000	725,000
	<u>2,505,000</u>	<u>1,414,000</u>
Total current assets	2,505,000	1,414,000
Property and equipment, net	6,060,000	6,461,000
Intangibles, net	8,183,000	8,416,000
Other assets	530,000	237,000
	<u>17,278,000</u>	<u>16,528,000</u>
Total assets	\$ 17,278,000	\$ 16,528,000
<b>LIABILITIES AND STOCKHOLDERS DEFICIT</b>		
<b>CURRENT LIABILITIES:</b>		
Accounts payable	\$ 2,695,000	2,750,000
Accrued salaries	471,000	511,000
Current portion of long term debt	2,134,000	750,000
Payable to related party	360,000	
Other current liabilities and accrued expenses	1,298,000	1,390,000
	<u>6,958,000</u>	<u>5,401,000</u>
Total current liabilities	6,958,000	5,401,000
<b>LONG-TERM LIABILITIES, LESS CURRENT PORTION</b>		
Subordinated loans from related party	6,592,000	5,684,000
Other long-term liabilities, less current portion	10,267,000	9,552,000
Convertible debt securities	2,121,000	1,859,000
	<u>18,980,000</u>	<u>17,095,000</u>
Total long-term liabilities	18,980,000	17,095,000
Total liabilities	25,938,000	22,496,000
<b>COMMITMENTS AND CONTINGENCIES</b>		
<b>STOCKHOLDERS DEFICIT</b>		
Preferred stock, par value \$0.01 per share, Authorized 100,000 shares; Issued and outstanding: none		
Preferred stock A, par value \$1.00 per share, authorized, issued and outstanding: none	3,394,000	3,473,000
Preferred stock B, par value \$1.00 per share, authorized, issued and outstanding: none	1,840,000	1,840,000
	<u>749,000</u>	<u>540,000</u>

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Common stock, par value \$.01 per share, Authorized 125,000,000 shares; Issued and outstanding: 74,850,328 and 53,352,000 shares		
Additional paid-in capital	52,565,000	50,105,000
Cumulative translation adjustments	(5,570,000)	(5,816,000)
Accumulated deficit	(200,000)	(200,000)
Deficit accumulated during development stage	(61,438,000)	(55,910,000)
	<u>                    </u>	<u>                    </u>
Total stockholders' deficit	(8,660,000)	(5,968,000)
	<u>                    </u>	<u>                    </u>
Total liabilities and stockholders' deficit	\$ 17,728,000	\$ 16,528,000
	<u>                    </u>	<u>                    </u>

See accompanying notes to consolidated financial statements.

## LITHIUM TECHNOLOGY CORPORATION AND SUBSIDIARIES

## (DEVELOPMENT STAGE COMPANIES)

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS

(UNAUDITED)

	THREE MONTHS ENDED MARCH 31,		PERIOD FROM FEBRUARY 12, 1999 (INCEPTION OF DEVELOPMENT STAGE) TO MARCH 31,
	2005	2004	2005
<b>REVENUES</b>			
Development contracts and prototype sales	\$ 142,000	\$ 87,000	\$ 1,258,000
<b>COSTS AND EXPENSES</b>			
Engineering, research and development	1,570,000	1,211,000	20,476,000
General and administrative	1,120,000	1,009,000	14,703,000
Depreciation and amortization	450,000	408,000	10,503,000
Intangibles expensed			3,700,000
Loss (gain) on sale of assets			108,000
	3,140,000	2,628,000	49,490,000
<b>OTHER INCOME (EXPENSE)</b>			
Foreign government subsidies	1,000	141,000	2,844,000
Interest expense, net of interest income	(725,000)	(677,000)	(8,079,000)
Interest expense related to Amortization of discount on convertible debt	(848,000)	(250,000)	(3,233,000)
	(1,572,000)	(786,000)	(8,468,000)
<b>NET LOSS</b>	<b>\$ (4,570,000)</b>	<b>\$ (3,327,000)</b>	<b>\$ (56,700,000)</b>
Charge for embedded derivative and warrants - preferred shares	(845,000)		(4,499,000)
Dividends on preferred shares	(113,000)		(239,000)
<b>NET LOSS TO COMMON SHAREHOLDERS</b>	<b>(5,528,000)</b>	<b>(3,327,000)</b>	<b>(61,438,000)</b>
<b>OTHER COMPREHENSIVE INCOME (LOSS)</b>			
Currency translation adjustments	246,000	783,000	(5,570,000)
<b>COMPREHENSIVE LOSS</b>	<b>\$ (5,282,000)</b>	<b>\$ (2,544,000)</b>	<b>\$ (67,008,000)</b>
Weighted average number of common shares outstanding:	59,259,391	10,744,264	
Basic and diluted net loss per share:	\$ (0.09)	\$ (0.31)	

See accompanying notes to consolidated financial statements.





## LITHIUM TECHNOLOGY CORPORATION AND SUBSIDIARIES

## (DEVELOPMENT STAGE COMPANIES)

## CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY (DEFICIT)

(UNAUDITED)

	Convertible Preferred Stock		Common Stock		Additional Paid-in Capital	Cumulative Transactions Adjustments	Accumulated Deficit	Deficit Accumulated During Development
	Shares	Amount	Shares	Amount				
Balances at December 31, 2004	5,313,000	\$ 5,313,000	53,923,964	\$ 540,000	\$ 50,105,000	\$ (5,816,000)	\$ (200,000)	\$ (55,910,000)
Charge for fair value of warrants					528,000			(528,000)
Charge for embedded derivative					317,000			(317,000)
Issuance of convertible preferred stock	476,000	476,000						
Stock issued for services			2,988,745	30,000	300,000			
Warrants issued for services					178,000			
Stock issued upon conversion of 10% convertible debentures			13,600,000	136,000	625,000			
Stock issued upon conversion of convertible preferred stock	(555,000)	(555,000)	4,337,619	43,000	512,000			
Dividend on convertible preferred stock								(113,000)
Foreign currency translation adjustments						246,000		
Net loss								(4,570,000)
Balances at March 31, 2005	5,234,000	\$ 5,234,000	74,850,328	\$ 749,000	\$ 52,565,000	\$ (5,570,000)	\$ (200,000)	\$ (61,438,000)

See accompanying notes to consolidated financial statements.

## LITHIUM TECHNOLOGY CORPORATION AND SUBSIDIARIES

## (DEVELOPMENT STAGE COMPANIES)

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	THREE MONTHS ENDED MARCH 31		PERIOD FROM FEBRUARY 12, 1999 (INCEPTION OF DEVELOPMENT STAGE) TO
	2005	2004	MARCH 31, 2005
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>			
Net loss	\$ (4,570,000)	\$ (3,327,000)	\$ (56,700,000)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	450,000	408,000	10,503,000
In-process research and development expensed			3,700,000
Loss on sale of assets		(1,000)	108,000
Non cash interest expense	1,533,000	853,000	9,497,000
Change in operating assets and liabilities, net of business acquisitions:			
Accounts receivable	47,000	(4,000)	(73,000)
Inventories	31,000	(5,000)	(77,000)
Prepaid expenses and other current assets	13,000	47,000	(322,000)
Accounts payable and accrued expenses	363,000	46,000	4,297,000
Net cash used in operating activities	(2,133,000)	(1,983,000)	(29,067,000)
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>			
Purchases of property and equipment	(10,000)	(26,000)	(4,600,000)
Investment in intangibles	(3,000)		(276,000)
Cash received in connection with Share Exchanges			20,000
Deposit on equipment	(119,000)		(345,000)
Proceeds from sale of assets			153,000
Net cash used in investing activities	(132,000)	(26,000)	(5,048,000)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>			
Repayments of loans from financial institutions	(131,000)	(63,000)	(2,259,000)
Proceeds (repayments) of silent partnership loans			102,000
Proceeds (repayments) from related party loans			16,908,000
Proceeds from 10% convertible debentures, net of cost of issue		1,686,000	1,686,000
Proceeds from 12% debentures	2,500,000		2,500,000
Proceeds from Series A & B Units, net of cost of issue	476,000		4,026,000
Proceeds received from non-convertible promissory notes from related party	908,000	408,000	12,869,000
Net cash provided by financing activities	3,753,000	2,031,000	35,832,000
Effect of exchange rate changes on cash	(3,000)	(3,000)	(9,000)
Net increase (decrease) in cash and cash equivalents	1,485,000	19,000	1,708,000
Cash and cash equivalents, beginning of period	226,000	127,000	3,000
Cash and cash equivalents, end of period	\$ 1,711,000	\$ 146,000	\$ 1,711,000

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SUPPLEMENTAL CASH FLOW INFORMATION			
Cash paid for interest	\$ 40,000	\$ 74,000	\$ 751,000
Conversion of convertible debt into common stock		\$ 3,949,000	35,752,000
Conversion of convertible debt into preferred stock		\$	3,545,000
Stock issued for services	330,000	85,000	436,000
Stock issued as a dividend on convertible preferred stock			126,000
Warrants issued for services	178,000		473,000
Conversion of bridge notes to debentures			3,000,000
Conversion of A Units into common stock	555,000		2,337,000
Conversion of January 2004 debentures into common stock	761,000		1,287,000
Capital contribution by affiliate of Arch Hill in lieu of debt payment			1,734,000

See accompanying notes to consolidated financial statements.

**LITHIUM TECHNOLOGY CORPORATION**

**AND SUBSIDIARIES**

**(DEVELOPMENT STAGE COMPANIES)**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1 BASIS OF PRESENTATION**

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and rules and regulations of the Securities and Exchange Commission (the "SEC") applicable to interim periods. In the opinion of management, all adjustments (consisting only of normal recurring accruals) considered necessary for a fair presentation have been included. These financial statements should be read in conjunction with the Company's audited financial statements included in the Company's Annual Report on Form 10-KSB filed with the Securities and Exchange Commission for the year ended December 31, 2004. Operating results for three months ended March 31, 2005 are not necessarily indicative of the results that may be expected for the year ending December 31, 2005 or any interim period.

**NOTE 2 ORGANIZATION, BUSINESS OF THE COMPANY AND RECENT DEVELOPMENTS**

In 2002, Lithium Technology Corporation ("LTC" or the "Company") closed share exchanges in which LTC acquired ownership of 100% of GAIA Holding B.V. ("GAIA Holding") from Arch Hill Ventures, N.V., a private company limited by shares, incorporated under the laws of the Netherlands ("Arch Hill Ventures"), which is controlled by Arch Hill Capital N.V. ("Arch Hill Capital"), a private company limited by shares, incorporated under the laws of the Netherlands (the "Share Exchanges"). In November 2004, Arch Hill Capital and Arch Hill Ventures transferred all LTC securities owned by such entities to Stichting Gemeenschappelijk Bezit GAIA ("Stichting GAIA") and Stichting Gemeenschappelijk Bezit LTC ("Stichting LTC"), entities controlled by Arch Hill Capital.

Subsequent to the Share Exchanges, Arch Hill Capital effectively controls LTC. As a result, the Share Exchanges have been accounted for as a reverse acquisition, whereby for financial reporting purposes, GAIA Holding is considered the acquiring company. Hence, the historical financial statements of GAIA Holding became the historical financial statements of the Company and include the results of operations of LTC only from the acquisition date of October 4, 2002.

GAIA Holding, a private limited liability company incorporated under the laws of the Netherlands, is the 100% beneficial owner of GAIA Akkumulatorenwerke GmbH ("GAIA"). GAIA Holding was incorporated in 1990 and only had limited operations until the acquisition of GAIA on February 12, 1999 (inception of development stage). GAIA is a private limited liability company incorporated under the laws of Germany. GAIA Holding's ownership interest in GAIA is held through certain trust arrangements (see Note 3).

The date of inception of the Company's development stage is February 12, 1999. Prior to inception of development stage activities, the Company incurred accumulated losses of \$200,000, and these losses have been segregated from the Company's deficit accumulated during the development stage in the consolidated financial statements.

The Company considers itself to have one operating segment. The Company is a development and pilot-line production stage company that develops large format lithium-ion rechargeable batteries to be used as a new power source for emerging applications in the automotive, stationary power, and national security markets.

**NOTE 3 SIGNIFICANT ACCOUNTING POLICIES**

**BASIS OF CONSOLIDATION**

The consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany accounts and transactions have been eliminated.

The financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or classification of liabilities that might be necessary should the Company be unable to operate in the normal course of business.

GAIA Holding is the beneficial owner of all of the issued and outstanding shares of GAIA. Legal ownership of the outstanding shares of GAIA are held pursuant to certain Dutch and German trust agreements by two Netherlands entities (the Nominal Stockholders ) for the risk and account of GAIA Holding. Based on the Dutch and German trust agreements, the Nominal Stockholders are obligated to transfer the legal ownership of the shares in GAIA without any further payments to GAIA Holding. Pursuant to the trust agreements, GAIA Holding has the right to vote the shares of GAIA held by the Nominal Stockholders. The results of GAIA are included in the results of GAIA Holding as of the date of acquisition.

#### **ESTIMATES AND UNCERTAINTIES**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America ( generally accepted accounting principles ) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results, as determined at a later date, could differ from these estimates.

#### **FAIR VALUE OF FINANCIAL INSTRUMENTS**

Fair value estimates, assumptions and methods used to estimate fair value of the Company s financial instruments are made in accordance with the requirements of SFAS No. 107, Disclosures about Fair Value of Financial Instruments. The Company has used available information to derive its estimates. However, because these estimates are made as of a specific point in time, they are not necessarily indicative of amounts the Company could realize currently. The use of different assumptions or estimating methods may have a material effect on the estimated fair value amounts.

The carrying amounts of cash and cash equivalents, accounts receivable, accounts payable, accrued expenses and short-term notes payable approximate fair value due to the short-term nature of the instruments.

Long-term liabilities are comprised of the loans from financial institutions, related party loans and other long-term loans. The Company s long-term loans from financial institutions and other long-term loans approximate fair value.

#### **CASH AND CASH EQUIVALENTS**

The Company considers all highly liquid investment instruments purchased with an initial remaining maturity of three months or less to be cash equivalents.

#### **INVENTORIES**

Inventories primarily include raw materials and auxiliary materials required for the production process. Inventories are valued at the lower of cost or net realizable value. The cost of inventories is determined by using the weighted average method. Cost elements included in inventories comprise all costs of purchase and other costs incurred to bring the inventories to their present location and condition.

#### **PROPERTY AND EQUIPMENT**

Property and equipment are recorded at cost and primarily consist of buildings, technical and lab equipment, furniture and office equipment and leasehold improvements. In the period assets are retired or otherwise disposed of, the costs and accumulated depreciation are removed from the accounts, and any gain or loss on disposal is included in results of operations. Property and equipment are depreciated using the straight-line method over their estimated useful lives as follows:

Buildings	25 years
Technical and laboratory equipment	7-14 years
Office equipment and other	1-5 years

#### **INTANGIBLES**

Intangibles consist of amounts capitalized by GAIA for patents, which are recorded at cost and are amortized using the straight-line method over their estimated useful lives of 13 to 17 years commencing upon final approval by the foreign regulatory body. Intangibles also include amounts relating to the core patented technology of LTC, as determined by an independent valuation, in connection with the allocation of the purchase price resulting from the Share Exchanges. These intangibles are being amortized using the straight-line method over their estimated useful lives of 12 years commencing October 4, 2002.

## **LONG-LIVED ASSETS**

The Company periodically evaluates the carrying value of long-lived assets when events and circumstances indicate the carrying amounts may not be recoverable. The carrying value of a long-lived asset is considered impaired when the anticipated undiscounted cash flows expected to result from the use and eventual disposition from such assets are less than the carrying value. If the sum of the expected cash flows (undiscounted and without finance charges) is less than the carrying amount of the asset, the Company recognizes an impairment loss on the asset. In that event, a loss is recognized for the amount by which the carrying value exceeds the fair value of the long-lived asset. Fair value is determined by quoted market prices in active markets, if available, or by using the anticipated cash flows discounted at a rate commensurate with the risks involved.

## **INCOME TAXES**

Deferred tax assets and liabilities are computed for temporary differences between the financial statement and tax bases of assets and liabilities that will result in taxable or deductible amounts in the future based on enacted tax laws and rates applicable to the periods in which the temporary differences are expected to affect taxable income. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized.

## **REVENUES**

The Company performs certain research and development for other companies and sells prototypes to third parties. Revenue is recognized as services are rendered or products are delivered, the price to the buyer is fixed and determinable, and collectibility is reasonably assured.

## **OTHER INCOME**

The Company receives subsidies from foreign governmental agencies to reimburse the Company for certain research and development expenditures. Subsidies are recorded as other income.

## **FOREIGN CURRENCY TRANSLATION**

The functional currency for foreign operations is the local currency. For these foreign entities, the Company translates assets and liabilities at end-of-period exchange rates. The Company records these translation adjustments in cumulative other comprehensive income (loss), a separate component of equity in the consolidated balance sheet. For revenues, expenses, gains and losses, the weighted average exchange rate for the period is used to translate those elements.

## **STOCK OPTIONS**



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In accordance with Statement of Financial Accounting Standard ( SFAS ) No. 123, Accounting for Stock-based Compensation (SFAS No. 123), the Company has elected to account for stock option grants to employees using the intrinsic value based method prescribed by APB Opinion No. 25.

### **NET LOSS PER COMMON SHARE**

The Company has presented net loss per common share pursuant to SFAS No. 128, Earnings Per Share . Net loss per common share is based upon the weighted average number of outstanding common shares. The Company has determined that the as-if converted common shares related to the preferred shares should be included in the weighted average shares outstanding for purposes of calculating basic earnings per share. These shares were converted to common stock in February 2004. The Company made such determination because: 1) Arch Hill Capital, which controls the Company, had the ability to authorize the necessary shares for conversion; 2) the preferred shares had no significant preferential rights above the common shares; and 3) the preferred shares would automatically convert at a later date upon proper share authorization. As a result, weighted average shares outstanding included in the

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calculation of basic and diluted net loss per common share for the three months ended March 31, 2005 and 2004 was as follows:

	Three Months Ended	Three Months Ended
	<u>March 31, 2005</u>	<u>March 31, 2004</u>
Series A Preferred Stock		3,425,863
Common Stock	59,259,391	7,318,401
<b>Total</b>	<b>59,259,391</b>	<b>10,744,264</b>

Due to net losses in the three months ended March 31, 2005 and 2004, the effect of the potential common shares resulting from convertible promissory notes payable, convertible debentures, stock options and warrants in those years was excluded, as the effect would have been anti-dilutive.

**RESTATEMENT OF MARCH 31, 2004 QUARTERLY RESULTS**

In connection with the audit of the Company's financial statements for the year ended December 31, 2004, the Company determined that generally accepted accounting principles were not correctly applied to certain complex financing transactions, and that adjustments to the Company's financial statements were required. The restatement relates to the accounting for the variable conversion feature on the Company's 10% Convertible Debentures and its Series A Convertible Preferred Stock. The conversion feature on the 10% Convertible Debentures and the Series A Convertible Preferred Stock has been determined to be an embedded derivative under SFAS 133, which is required to be reflected as a liability at fair value. The 10% Convertible Debentures were previously reflected as containing a beneficial conversion feature under EITF 98-5. The adjustments relate solely to the accounting treatment of these transactions and do not affect the Company's historical cash flow.

The following table sets forth the affect of the restatement on the three month period ended March 31, 2004:

<u>Three months ended March 31, 2004</u>	<u>As restated</u>	<u>As reported</u>
Net loss	(3,327,000)	(4,229,000)
Net loss to common shareholders	(3,327,000)	(4,229,000)
Basic and diluted net loss To common shareholders per share	(0.31)	(0.35)

This Report on Form 10-QSB for the quarter ended March 31, 2005, reflects corrections and restatements of the following financial statements: (a) condensed consolidated statements of operations and comprehensive loss for the quarter ended March 31, 2004; and (b) condensed consolidated statements of cash flows for the quarter ended March 31, 2004.

## RECENT ACCOUNTING PRONOUNCEMENTS

On December 16, 2004, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 123(R), *Share-Based Payment* , which is a revision of SFAS No. 123 and supersedes APB Opinion 25. SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be valued at fair value on the date of grant, and to be expensed over the applicable vesting period. Pro forma disclosure of the income statement effects of share-based payments is no longer an alternative. SFAS No. 123(R) is effective for all stock-based awards granted on or after January 1, 2006. In addition, companies must also recognize compensation expense related to any awards that are not fully vested as of the effective date. Compensation expense for the unvested awards will be measured based on the fair value of the awards previously calculated in developing the pro forma disclosures in accordance with the provisions of SFAS No. 123.

The Company plans to adopt SFAS No. 123(R) on January 1, 2006. This change in accounting is not expected to materially impact its financial position. The Company has not completed the calculation of this impact. However, because the Company currently accounts for share-based payments to its employees using the intrinsic value method, its results of operations have not included the recognition of compensation expense for the issuance of stock option awards.

On December 16, 2004, the FASB issued SFAS No. 153, *Exchanges of Nonmonetary Assets* , which is an amendment to APB Opinion No. 29. It states that the exchanges on nonmonetary assets should be measured based on the fair value of the assets exchanged. Further, FSAS No. 153 eliminates the narrow exception for nonmonetary exchanges of similar productive assets and replaces it with a broader exception for exchanges of nonmonetary assets that do not have commercial substance . FSAS No. 153 is effective for financial statements for fiscal years beginning after June 15, 2005. Earlier application is permitted for nonmonetary asset exchanges incurred during fiscal years beginning after the date that this statement is issued. Management believes the adoption of this Statement will not have an effect on the consolidated financial statements.

On November 24, 2004, FASB issued SFAS No. 151, *Inventory Costs* , which is an amendment to ARB No. 43, Chapter 4. It clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). The FASB states that these costs should be expensed as incurred and not included in overhead. Further, SFAS No. 151 requires that allocation of fixed production overheads to conversion costs should be based on normal capacity of the production facilities. SFAS No. 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. Management believes the adoption of this Statement will not have an effect on the consolidated financial statements.

In December 2003, the FASB issued FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*. ( VIEs ) ( FIN 46R ) which addresses how a business enterprise should evaluate whether it has a controlling financial interest in an entity through means other than voting rights and accordingly should consolidate the entity. FIN 46R replaces FASB Interpretation No. 46. *Consolidation of Variable Interest Entities*, which was issued in January 2003. The Company has adopted FIN 46R as of March 31, 2004 for variable interests in VIEs. For any VIEs that must be consolidated under FIN 46R that were created before January 1, 2004, the assets, liabilities and noncontrolling interests of the VIE initially would be measured at their carrying amounts with any difference between the net amount added to the balance sheet and any previously recognized interest being recognized as the cumulative effect of an

accounting change. If determining the carrying amounts is not practicable, fair value at the date FIN 46R first applies may be used to measure the assets, liabilities and noncontrolling interest of the VIE. The adoption of FIN 46R did not have an effect on the consolidated financial statements inasmuch as the Company has no interests in any VIEs.

**NOTE 4 OPERATING AND LIQUIDITY DIFFICULTIES AND MANAGEMENT S PLANS TO OVERCOME**

Over the past four years, the Company has refocused its unique extrusion-based manufacturing process, cell technology, large battery assembly expertise, and market activities to concentrate on large-format, high rate battery applications. The Company s commercialization efforts are focused on applying its lithium-ion rechargeable batteries in the national security, transportation and stationary power markets.

The Company s operating plan seeks to minimize its capital requirements, but commercialization of its battery technology will require additional capital. The Company expects that technology development and operating and production expenses will increase significantly as it continues to advance its battery technology and develop products for commercial applications.

The Company operations have been financed primarily through the use of proceeds from equity financings, loans, including loans from Arch Hill Capital, Arch Hill Ventures and other related parties, loans from silent partners and bank borrowings secured by assets.

The Company has recently entered into a number of financing transactions and are continuing to seek other financing initiatives to meet its working capital needs and to complete its product commercialization process. See Notes 7, 8, 10 and 11. Such capital is expected to come from the sale of securities, including the sale of common stock under the Standby Equity Distribution Agreement. See Note 10.

No assurance can be given that the Company will be successful in completing these or any other financings at the minimum level necessary to fund its capital equipment requirements, current operations or at all. If the Company is unsuccessful in completing these financings at such minimum level, it will not be able to fund its capital equipment requirements or current expenses or it will not be able to pursue its business strategy. Additional financing may not be available on terms favorable to the Company or at all.

**NOTE 5 PROPERTY AND EQUIPMENT**

Property and equipment at March 31, 2005 and December 31, 2004 is summarized as follows:

	<u>March 31</u>	<u>December 31</u>
Land and buildings	\$ 2,848,000	\$ 3,009,000
Technical and laboratory equipment	6,383,000	6,794,000
Asset under construction and equipment deposit	130,000	12,000
Office equipment and other	567,000	622,000
	<u>9,928,000</u>	<u>10,437,000</u>

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Less: Accumulated depreciation and amortization	<u>(3,868,000)</u>	<u>(3,976,000)</u>
	<u>\$ 6,060,000</u>	<u>\$ 6,461,000</u>

Assets under construction at March 31, 2005 included equipment being constructed that was not yet placed into service.

**NOTE 6 INTANGIBLES**

Intangibles at March 31, 2005 and December 31, 2004 are summarized as follows:

	<u>March 31</u>	<u>December 31</u>
Patents	\$ 10,278,000	\$ 10,302,000
Less: Accumulated amortization	(2,095,000)	(1,886,000)
<b>Total</b>	<b>\$ 8,183,000</b>	<b>\$ 8,416,000</b>

Intangibles consist primarily of amounts relating to the core patented technology of LTC, as determined by an independent valuation, in connection with the allocation of the excess purchase price resulting from the Share Exchanges (see Note 2). Intangibles also include patents held by GAIA Holding.

Amortization expense on intangible assets was \$209,000 and \$836,000, respectively, in the three months ended March 31, 2005 and the year ended December 31, 2004. Estimated future amortization expense on intangible assets for the next five years, at March 31, 2005, is approximately \$840,000 per year.

**NOTE 7 CONVERTIBLE DEBT SECURITIES****CONVERTIBLE DEBT SECURITIES**

Convertible debt securities are comprised of bridge notes held by Arch Hill Capital and 10% Convertible Debentures Due 2006 held by an investment group and Arch Hill Capital.

**BRIDGE NOTES**

The bridge notes were issued under a Bridge Financing Agreement, as amended, between LTC and Arch Hill Capital (the Bridge Financing Agreement).

All amounts outstanding under the Bridge Financing Agreement through April 13, 2004 were converted to Company securities on April 13, 2004, pursuant to a Debt Exchange Agreement between the Company, GAIA Holding, GAIA, Arch Hill Capital and Arch Hill Ventures (the April 2004 Bridge Exchange). From April 14, 2004 through August 30, 2004 Arch Hill Capital advanced \$3,545,000 of bridge notes which were exchanged for \$1,705,000 of A Units and \$1,840,000 of B Units on August 30, 2004. (See Note 10) As of December 31, 2004, no bridge notes were outstanding under the Bridge Financing Agreement. During the first quarter of 2005 \$175,000 of bridge notes were issued under the Bridge

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Financing Agreement and remain outstanding as of March 31, 2005. The Bridge Financing Agreement does not contain a maximum of the amount of funding that may be advanced under such Agreement. The amount of any additional notes provided will be related to the working capital advances made by Arch Hill Capital to the Company.

**APRIL 2004 10% CONVERTIBLE DEBENTURES**

The April 2004 debentures had a maturity date of April 13, 2006. Interest payments on the April 2004 debentures are due and payable in cash, or at the option of Arch Hill Capital, in Company common stock at a price equal to the conversion price of our common stock as described below. Interest is due quarterly commencing September 30, 2004. Any amount of principal or interest on the April 2004 debentures which is not paid when due bears interest at 15% per annum from the due date of such payment default.

The April 2004 debentures are convertible at any time at the option of the holder into shares of Company common stock. The conversion price of Company common stock used in calculating the number of shares issuable upon conversion, or in payment of interest on the April 2004 debentures, is the lesser of:

50% of the average of the lowest three trading prices of our common stock for the twenty trading days ending one trading day prior to the date the Company receives a conversion notice from a 10% debenture holder; and

a fixed conversion price of \$2.00.

In connection with the April 2004 debentures, the Company issued warrants to purchase 1,500,000 shares of Company common stock at an exercise price of \$2.00 per share and warrants to purchase 10,500,000 shares of Company common stock at \$2.40 per share.

The warrants expire on April 13, 2009. The warrants are subject to exercise price adjustments upon the occurrence of certain events including stock dividends, stock splits, mergers, reclassifications of stock or our recapitalization. The exercise price of the warrants is also subject to reduction if the Company issues any rights, options or warrants to purchase shares of Company common stock at a price less than the market price of Company shares as quoted on the OTC Bulletin Board, subject to certain exceptions. Also, if at any time, the Company declares a distribution or dividend to the holders of Company common stock in the form of cash, indebtedness, warrants, rights or other securities, the holders of the warrants are entitled to receive the distribution or dividend as if the holder had exercised the warrant.

The above conversion formula resulted in the debentures being issued with an embedded derivative. Accordingly, pursuant to FASB 133 Accounting for Derivative Instruments and Hedging Activities, the Company has recorded the entire \$3,000,000 to the derivative instrument based on the fair value of the embedded derivative. The \$3,000,000 discount is being recognized as interest over the two year life of the debentures or conversion date which ever is earlier.

In December 2004, \$3,000,000 of April 2004 Debentures and accrued and unpaid interest were converted into 42,619,718 shares of common stock. The April 2004 debentureholder is entitled to acquire from the Company pursuant to a Notice of Conversion dated December 8, 2004 40,000,000 fully paid and nonassessable shares of Company common stock pursuant to the conversion of \$3,000,000 principal amount of debentures, and 2,619,178 shares of Company common stock in payment of \$196,438.36 of accrued and unpaid interest on the debentures, for a total of 42,619,178 shares of Company common stock. Certificates for the shares must be delivered no later than ten days of an increase in the authorized number of shares of Company common stock subsequent to the conversion date.

**JANUARY 2004 - 10% CONVERTIBLE DEBENTURES**



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On January 20, 2004, the Company entered into a securities purchase agreement with an investment group to purchase \$2,000,000 of the Company's 10% Convertible Debentures Due 2006 (the January 2004 debentures) with attached warrants to purchase up to 1,000,000 shares of LTC common stock. On January 22, 2004 the Company closed the convertible debenture financing.

The January 2004 debentures have a maturity date of January 20, 2006. Interest payments on the January 2004 debentures are due and payable in cash, or at the option of the January 2004 debenture holder, in Company common stock at a price

equal to the conversion price of Company common stock as described below. Interest is due quarterly commencing March 31, 2004. Any amount of principal or interest on the January 2004 debentures which is not paid when due bears interest at 15% per annum from the due date of such payment default.

The January 2004 debentures are secured by security agreements under which the Company pledged substantially all of its assets, including its goods, fixtures, equipment, inventory, contract rights, receivables and intellectual property and certain equipment of GAIA.

The January 2004 debentures are convertible at any time at the option of the holder into shares of Company common stock. The conversion price of Company common stock used in calculating the number of shares issuable upon conversion, or in payment of interest on the 10% debentures, is the lesser of:

50% of the average of the lowest three trading prices of our common stock for the twenty trading days ending one trading day prior to the date the Company receives a conversion notice from a January 2004 debenture holder; and

a fixed conversion price of \$2.00.

The Company has the right to prepay all or a portion of the outstanding January 2004 debentures and accrued and unpaid interest upon prior written notice to the holders of the January 2004 debentures in an amount equal to 150% for prepayment of principal and interest occurring after April 18, 2004. If the Company prepays the outstanding January 2004 debentures, the Company must issue an aggregate of 2.5% of the total issued and outstanding Company common stock to the January 2004 debenture holders on a pro rata basis.

The January 2004 debentures include warrants to purchase 1,000,000 shares of LTC common stock at an exercise price of \$2.00 per share. The warrants expire on January 20, 2009. The warrants are subject to exercise price adjustments upon the occurrence of certain events including stock dividends, stock splits, mergers, reclassifications of stock or the Company's recapitalization. The exercise price of the warrants is also subject to reduction if the Company issues any rights, options or warrants to purchase shares of common stock at a price less than the market price of Company shares as quoted on the OTC Bulletin Board, subject to certain exceptions. Also, if at any time, the Company declares a distribution or dividend to the holders of common stock in the form of cash, indebtedness, warrants, rights or other securities, the holders of the warrants are entitled to receive the distribution or dividend as if the warrant holders had exercised the warrants.

The conversion feature resulted in the debentures being issued with an embedded derivative. Accordingly, pursuant to FASB 133 Accounting for Derivative Instruments and Hedging Activities, the Company has recorded the entire \$2,000,000 of the proceeds received to the liability for the derivative instrument based on the fair value of the embedded derivative. The \$2,000,000 discount will be recognized as interest over the two year life of the debentures or conversion date which ever is earlier.

On May 5, 2004, the Company issued to the finder and affiliated persons in the January 2004 debenture financing warrants to purchase shares of Company common stock. The warrants entitle the holders to purchase, in the aggregate, such number of shares of the common stock equal to 10% of the aggregate number of fully diluted and/or converted shares of common stock as are purchased by the January 2004 debenture holders (after giving effect to any increase in shares under a ratchet or similar provision pursuant to which the number of shares initially purchased is subsequently increased). The exercise price per share of the warrants is equal to 110% of the effective per share price paid by the January 2004 debenture holders for the securities purchased by such debenture holders. The warrants are exercisable until January 20, 2009. As of March 31, 2005, the finder and affiliated persons held vested warrants to purchase 4,180,000 shares of Company common stock at exercise prices ranging from \$0.024 to \$0.660 per share.

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During the quarter ended March 31, 2005, \$761,050 of January 2004 debentures were converted into an aggregate of 13,600,000 shares of common stock at conversion prices ranging from \$0.0405 to \$0.0766 per share. As of March 31, 2005, \$712,850 of January 2004 debentures were outstanding. Additional January 2004 debentures were converted into shares of Company common stock after March 31, 2005. (See Note 11).

**NOTE 8 LONG-TERM DEBT**

	<u>March 31, 2005</u>	<u>December 31, 2004</u>
Long-term debt is summarized as follows:		
Convertible debt securities (Note 7)	\$ 2,121,000	\$ 1,859,000
Derivative liability (Notes 7 and 10)	5,411,000	5,410,000
Loans from financial institutions	1,993,000	2,254,000
Debentures	2,500,000	
Subordinated loans from related party	6,592,000	5,684,000
Silent partnership loans	2,497,000	2,638,000
	<u>\$ 21,114,000</u>	<u>\$ 17,875,000</u>
Less: Current maturities	(2,134,000)	(750,000)
	<u>\$ 18,980,000</u>	<u>\$ 17,095,000</u>

**LOANS FROM FINANCIAL INSTITUTIONS**

GAIA has two loans from financial institutions that are collateralized by the following assets of GAIA: (i) land and buildings in an amount up to \$1,220,000 and (ii) machinery, equipment and patents in an amount of \$2,608,000 as collateral for the mortgage loan. The loans bear interest between 5.75% and 6.75% per annum and are scheduled to be repaid by December 31, 2014.

**SUBORDINATED LOANS FROM RELATED PARTY**

GAIA has received subordinated loans from Arch Hill Ventures, a related party. The loans bear cumulative interest at 6% per annum. Under the subordinated loan agreement (the "Subordinated Loan Agreement") terms, the loans can be called when GAIA does not have negative stockholders' equity. The loans are subordinated to all other creditors of GAIA. A portion of the subordinated loans from Arch Hill Ventures (\$23,185,604), were converted to 21,001,453 of Company shares on April 13, 2004 (See Note 10).

**SILENT PARTNERSHIP LOANS-NON-RELATED PARTIES**

Two other parties have provided silent partnership loans to GAIA which remain outstanding at March 31, 2005. Frankendael Participatiemaatschappij N.V. ("Frankendael") has provided a partnership loan of \$516,000, which bears interest at 6% per annum. Technologie-Beteiligungs-Gesellschaft GmbH der Deutschen Ausgleichsbank ("TBG") has provided a partnership loan of \$1,981,000, which bears interest at 6% per annum. GAIA is not required to pay the interest under the Frankendael Partnership Agreement until GAIA has generated an accumulated profit amounting to \$4,953,000. The total amount payable to Frankendael and TBG under the Partnership Agreements at March 31, 2005 is \$2,497,000.

Frankendael and TBG are entitled to receive an annual 12% share in profits related to its contributions under the Frankendael Partnership Agreement and the TBG Partnership Agreement. The 12% share in profits under the Frankendael Partnership Agreement is not payable until

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GAIA has generated an accumulated profit amounting to \$4,953,000. The TBG Partnership Agreement provides that should GAIA receive additional injections of capital in the course of further financing rounds, TBG shall adjust its profit sharing to the capital ratio applicable at such time. Management believes that based upon subsequent equity received by GAIA that the present profit sharing that TBG is entitled to under the Agreement is approximately 4.4%. Management further believes that it is unlikely that Frankendael or TBG will receive any profit sharing under the Partnership Agreement at any time in the near future.

From March 8, 2005 under the TBG Partnership Agreement, TBG is entitled to demand a non-recurrent remuneration of 30% of the amount invested plus 6% of the amount invested at the end of the period of participation for each year after the expiration of the fifth full year of participation under certain circumstances relating to the economic condition of GAIA.

The Frankendael Partnership Agreement and the TBG Partnership Agreement each terminates in December 2008, unless terminated prior to such time for good cause as defined in the applicable partnership agreement.

The principal, accrued and unpaid interest, and unpaid profits, if any, are due on the termination of the Frankendael Partnership Agreement and the TBG Partnership Agreement.

## **MARCH 2005 DEBENTURE**

On March 11, 2005, the Company issued debentures in the principal amount of \$2,500,000. The debentures accrue interest at 12% per year and are repayable in 10 equal monthly installments with accrued interest commencing July 15, 2005 and ending April 15, 2006. In connection therewith, the Company entered into an Escrow Agreement under which put notices under the Standby Equity Distribution Agreement were deposited and certain monies received under that agreement will be received and forwarded to the debentureholder. Ten monthly put notices are held in escrow, each in the amount of \$250,000 commencing July 2005 and ending April 2006. \$250,000 per month being funded under the Standby Equity Distribution Agreement to the Company is to be delivered to the escrow account and be used to repay the debenture if the Company does not repay the debenture from other sources of capital.

## **NOTE 9 COMMITMENTS AND CONTINGENCIES**

### **BUILDING LEASE**

The Company leases a 12,400 square foot research facility and corporate headquarters in a freestanding building at 5115 Campus Drive in Plymouth Meeting, Pennsylvania pursuant to a Lease Agreement dated July 22, 1994, as amended, between PMP Whitmarsh Associates and the Company. The Company is currently leasing the facility under a one-year lease extension that ends on March 31, 2006. The annual rent under the lease is \$153,000 from April 1, 2005 to March 31, 2006.

### **CONSULTING AGREEMENTS**

On July 12, 2004, the Company entered into a Consulting Agreement with Ilion Technology Corporation ( "Ilion" ) pursuant to which Ilion will provide technology consulting services to the Company in the lithium battery field in consideration of \$15,000 and a four year warrant to purchase 35,000 shares of Company common stock at an exercise price of \$1.37 (the "Consulting Agreement" ). The Consulting Agreement has a term of July 12, 2004 to September 15, 2004 (the "Term" ) unless extended. If, by the end of the Term, the shares of Company common stock owned by Ilion (the "Shares" ) are not purchased in a private transaction pursuant to an Agreement dated July 12, 2004 between Ilion and the purchaser named therein or otherwise, the Term shall be extended on a month to month basis. During any such extension, the Company is obligated to make payments to Ilion of \$24,100 per month commencing on September 15, 2004 and ending on August 15, 2005 and Ilion will be obligated to transfer 1/12 of the Shares to the Company. In the event the Company does not make any such monthly payment, Ilion is entitled to 1/12 of the Shares for each month that the payment is not made. The Company did not make the monthly payments for the months September through March 2005 and Ilion retained 1/12 of the Shares for each of the foregoing months.

GAIA entered into a Consultancy Agreement with Innoventis Consulting GmbH with respect to the services of Dr. Franz Kruger as the Chairman of Management of GAIA pursuant to which Innoventis represented Dr. Kruger. The Consultancy Agreement was terminated on March 31, 2005. Innoventis charged a monthly fee of \$23,000 (\$31,381) for Dr. Kruger's services.

## **NOTE 10 STOCKHOLDER S EQUITY**

### **APRIL 2004 DEBT EXCHANGE**

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On April 13, 2004, pursuant to a Debt Exchange Agreement between the Company, GAIA Holding, GAIA, Arch Hill Capital and Arch Hill Ventures, the Company exchanged debt owed to Arch Hill Capital by the Company and debt owed to Arch Hill Ventures by GAIA for Company debentures and equity securities. \$1,587,375 of bridge notes held by Arch Hill Capital and issued by the Company in 2002 were exchanged for \$1,587,375 of April 2004 debentures and warrants to

purchase up to 793,688 shares of the Company common stock exercisable at \$2.00 per share. \$1,412,625 of bridge notes held by Arch Hill Capital and issued by the Company in 2003 were exchanged for \$1,412,625 of April 2004 debentures and warrants to purchase up to 706,312 shares of the Company common stock exercisable at \$2.00 per share. \$5,459,502 of bridge notes issued in 2003 and \$918,159 of bridge notes issued by the Company from January 1, 2004 through April 13, 2004 and \$323,284 of interest on the bridge notes issued in 2003 and 2004 were exchanged for 6,069,697 shares of the Company common stock and warrants to purchase up to 10,500,000 shares of the Company common stock exercisable at \$2.40 per share. \$23,185,604 of debt owed to Arch Hill Ventures by GAIA as of April 13, 2004 was exchanged for 21,001,453 shares of the Company common stock. (See Notes 7 and 8).

In December 2004, \$3,000,000 of April 2004 Debentures and accrued and unpaid interest were converted by Stichting LTC into 42,619,718 shares of common stock. Stichting LTC is entitled to acquire from us pursuant to a Notice of Conversion dated December 8, 2004 40,000,000 fully paid and nonassessable shares of our Common Stock pursuant to the conversion of \$3,000,000 principal amount of debentures, and 2,619,178 shares of Common Stock in payment of \$196,438.36 of accrued and unpaid interest on the debentures, for a total of 42,619,178 shares of Common Stock. Certificates for the Shares must be delivered by us to Stichting LTC within ten days of an increase in the authorized number of shares of Company Common Stock subsequent to the conversion date, provided stock Certificates are delivered no later than June 1, 2005.

#### PRIVATE PLACEMENT OF A UNITS AND B UNITS

During the fiscal year ended December 31, 2004, the Company closed on the sale of \$7,342,000 of its securities in a private placement. The Company closed on the sale of \$3,797,000 of A Units ( A Units ) for cash. The Company also issued 1,705 of A Units in exchange for \$1,705,000 of outstanding debt and 1,840 of B Units ( B Units ) in exchange for \$1,840,000 of outstanding debt, in each case held by Arch Hill Capital. The exchange was based on the terms of the bridge financing agreement between the Company and Arch Hill Capital, which gives Arch Hill Capital the option to apply the principal balance and all other sums due and payable under any promissory notes issued by the Company to it on or after January 1, 2003 against the purchase price of equity securities being sold by the Company in any equity financing after the date of such notes. During the quarter ended March 31, 2005, the Company closed on the sale of \$560,000 A Units for cash. Subsequent to March 31, 2005, the Company amended the terms of the B Units. (See Note 11)

As of March 31, 2005 each A Unit consisted of:

- (i) one share of Series A Convertible Preferred Stock, par value \$0.01 per share (the Series A Preferred Stock ),
- (ii) one warrant for each share of common stock issued upon conversion of the Series A Preferred Stock, each warrant to purchase 1/2 of a share of common stock at an exercise price per share equal to 125% of the conversion price of the Series A Preferred Stock then in effect upon conversion of the shares of Series A Preferred Stock by the stockholder from time to time (the 125% A Warrant ), and
- (iii) one warrant for each share of common stock issued upon conversion of the Series A Preferred Stock, each warrant to purchase 1/2 of a share of common stock at an exercise price per share equal to 150% of the conversion price of the Series A Preferred Stock then in effect upon conversion of the shares of Series A Preferred Stock by the stockholder from time to time (the 150% A Warrant ).

As of March 31, 2005 each B Unit consisted of:

- (i) one share of Series B Convertible Preferred Stock, par value \$0.01 per share (the Series B Preferred Stock ),



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- (ii) one warrant for each share of common stock issued upon conversion of the Series B Preferred Stock, each warrant to purchase one share of its common stock at an exercise price per share equal to \$2.25 (the 125% B Warrant ), and
  
- (iii) one warrant for each share of common stock issued upon conversion of the Series B Preferred Stock, each warrant to purchase one share of common stock at an exercise price per share equal to \$2.70 (the 150% B Warrant ).

The shares of Series A Preferred Stock are entitled to receive an 8% annual cumulative dividend payable in shares of common stock and rank pari passu with the Series B Preferred Stock.

The shares of Series B Preferred Stock are entitled to receive an 8% annual cumulative dividend payable in shares of common stock and rank pari passu with the Series A Preferred Stock.

As of the closing dates of the private placement, a sufficient number of shares of Series A Preferred Stock and Series B Preferred Stock (together the Preferred Stock ) were not available for issuance under the Company's certificate of incorporation. The Company has agreed to take all reasonable actions to promptly seek stockholder approval to amend its certificate of incorporation to increase the number of authorized shares of Preferred Stock to allow for the issuance of the Preferred Stock. Upon receipt of such stockholder approval, the Company will amend its certificate of incorporation to increase the number of authorized shares of Preferred Stock and deliver the Preferred Stock to the investors. Pending the amendment of its certificate of incorporation to increase the number of authorized shares of Preferred Stock, the private placement investors may request that the Company deliver notes convertible into that number of shares of common stock into which the Preferred Stock would be convertible and on all other terms comparable to the terms of the Preferred Stock. Upon such request, the Company will deliver such notes to investors.

The Series A Preferred Stock, the 125% A Warrants, the 150% A Warrants, the Series B Preferred Stock, the 125% B Warrants and 150% B Warrants (and the underlying conversion and warrant shares) constitute restricted securities and may be sold only upon registration under the Securities Act or upon reliance on an exemption from such registration requirements. Series A Preferred stockholders and Series B Preferred stockholders have the following registration rights with respect to the shares of common stock into which the Series A Preferred Stock, the 125% A Warrants, the 150% A Warrants, the Series B Preferred Stock, the 125% B Warrants and 150% B Warrants are exercisable. The Company has agreed to undertake to file with the Securities and Exchange Commission a registration statement covering the underlying shares of common stock at its expense commencing 180 days following the last date of sale of the A and B Units (which last sale date may not be later than January 31, 2005). The Company has agreed to use its best efforts to have the registration statement declared effective within 60 days of the filing of the registration statement.

The shares of Series A Preferred Stock are convertible at the election of the holder thereof, at any time commencing from and after their date of issuance and for a period of three years thereafter, upon five days' advance written notice to the Company. The conversion price is equal to 80% of the average closing price of the common stock on the OTC Bulletin Board for the 20 trading days immediately preceding the day upon which the Company receives a conversion notice from the Series A Preferred stockholder.

The 125% A Warrants and 150% A Warrants are exercisable for shares of common stock at any time beginning on the date of conversion of the Series A Preferred Stock and ending on the fifth anniversary of their issuance. The 125% A Warrants and 150% A Warrants are subject to adjustment for anti-dilution purposes.

The shares of Series B Preferred Stock are convertible at the election of the holder thereof, at any time commencing from and after their date of issuance and for a period of three years thereafter, upon five days' advance written notice to the Company. The conversion price as of March 31, 2005 is equal to \$1.80 per share.

The 125% B Warrants and 150% B Warrants are exercisable for shares of common stock at any time beginning on the date of conversion of the Series B Preferred Stock and ending on the fifth anniversary of their issuance. The 125% B Warrants and 150% B Warrants are subject to adjustment for anti-dilution purposes.

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During the fiscal year ended December 31, 2004, the holders of 1,797 A Units exchanged the Series A Preferred Stock rights into \$1,797,000 principal of promissory notes convertible into that number of shares of common stock into which the Series A Preferred Stock would be convertible and have converted \$1,782,000 of such notes into an aggregate of 10,761,660 shares of Company common stock at conversion prices ranging from \$.15 to \$.23 per share.

During the quarter ended March 31, 2005, the holders of 5,500 A Units exchanged the Series A Preferred Stock rights into \$550,000 principal of promissory notes convertible into that number of shares of common stock into which the Series A Preferred Stock would be convertible and have converted \$550,000 of such notes into an aggregate of 4,227,953 shares of Company common stock at conversion prices ranging from \$0.12 to \$0.18 per share. As of March 31, 2005 3,725 A Units and 1,840 B Units were outstanding. Subsequent to March 31, 2005, additional A Units were converted into Company common stock and the terms of the B Units were amended. See Note 11.

### **PREFERRED STOCK**

LTC's Certificate of Incorporation authorizes up to 100,000 shares of preferred stock. All preferred shares have been issued and converted into common stock and no preferred shares are available for issuance at March 31, 2005.

## **STANDBY EQUITY DISTRIBUTION AGREEMENT**

On March 11, 2005, the Company entered into a Standby Equity Distribution Agreement with Cornell Capital pursuant to which it may, at its discretion, periodically sell to Cornell Capital shares of Company common stock for a total purchase price of up to \$15,000,000. For each share of common stock purchased under the Standby Equity Distribution Agreement, Cornell Capital will pay the Company 98% of the lowest volume weighted average price of Company common stock as quoted by on the Over-the-Counter Bulletin Board or other principal market on which its common stock is traded for the five days immediately following the date the Company delivers a notice requiring Cornell Capital to purchase Company shares under the Standby Equity Distribution Agreement.

Cornell Capital Partner's obligation to purchase shares of Company common stock under the Standby Equity Distribution Agreement is subject to certain conditions, including the Company obtaining an effective registration statement for shares of common stock sold under the Standby Equity Distribution Agreement (the Registration Statement) and is limited to \$200,000 per weekly advance and \$800,000 per 30 days.

The commitment period under the Standby Equity Distribution Agreement expires on the earliest to occur of (i) the date on which Cornell Capital has purchased an aggregate amount of \$15,000,000 shares of its common stock under the Standby Equity Distribution Agreement, (ii) the date occurring twenty-four months after the Effective Date, or (iii) the date the Agreement is earlier terminated (in the event that (x) there occurs any stop order or suspension of the effectiveness of the Registration Statement for an aggregate of fifty trading days, other than due to the acts of Cornell Capital, during the commitment period, and (y) the Company fails materially to comply with any of the covenants contained in the Standby Equity Distribution Agreement and such failure is not cured within thirty days after receipt of written notice from Cornell Capital, provided, however, that this termination provision does not apply to any period commencing upon the filing of a post-effective amendment to the Registration Statement and ending upon the date on which such post effective amendment is declared effective by the SEC).

The Company has agreed to pay Cornell Capital 5% of the proceeds that it receives under the Standby Equity Distribution Agreement. In addition, upon execution of the Standby Equity Distribution Agreement, the Company paid Cornell Capital a commitment fee of 2,922,078 shares of Company common stock. The Company has paid Yorkville Advisors Management, LLC a fee of \$15,000 for structuring and legal expenses and \$5,000 for due diligence expenses. The Company has paid Newbridge Securities Corporation a fee of \$10,000 in Company common stock (66,667 shares) under a placement agent agreement relating to the Standby Equity Distribution Agreement.

As of March 31, 2005 the Company had not filed the Registration Statement registering the shares issuable under the Standby Equity Distribution Agreement and no shares were issued under the Standby Equity Distribution Agreement.

## **NOTE 11 SUBSEQUENT EVENTS**

### **JANUARY 2004 DEBENTURE**

From April 1, 2005 to May 24, 2005, the holders of the January 2004 debentures (see Note 7) converted \$687,970 of the January 2004 debentures into an aggregate of 27,300,000 shares of Company common stock, pursuant to the terms of the January 2004 debentures at conversion prices ranging from \$0.0363 to \$0.0221 per share. As of May 24, 2005, \$24,880 in principal of January 2004 debentures were outstanding.

**A AND B UNITS**

During the period April 1, 2005 to May 24, 2005, the holders of 1,715 A Units (see Note 10) exchanged the Series A Preferred Stock rights into \$1,715,000 principal of promissory notes convertible into that number of shares of common stock into which the Series A Preferred Stock would be convertible. The holders of \$20,000 notes converted such notes into an aggregate of 400,000 shares of Company common stock at a conversion price of \$0.05 per share and the holders of 1,840 B Units exchanged the Series B Preferred Stock rights into \$1,840,000 principal of promissory notes convertible into that number of shares of common stock into which the Series B Preferred Stock would be convertible.

On May 11, 2005, the Company amended the terms of the B Units to the same terms of the A Units. Prior to the amendment, each B Unit consisted of one share of Series B Convertible Preferred Stock, par value \$0.01 per share convertible into common stock at \$1.80 per share, one warrant for each share of common stock issued upon conversion of

the Series B Preferred Stock each warrant to purchase one share of common stock at an exercise price per share equal to \$2.25, and one warrant for each share of common stock issued upon conversion of the Series B Preferred Stock, each warrant to purchase one share of common stock at an exercise price per share equal to \$2.70. All of the B Units are held by Stichting LTC, an entity controlled by Arch Hill Capital. The Amendment is subject to the B Unitholders providing indirectly (through introducing third party investors to LTC) or directly debt or equity capital to us of not less than \$2,000,000 on or after the date of the Amendment and no later than December 31, 2005 on terms acceptable to us. In the event the capital is not provided by December 31, 2005, the Amendment shall be void on such date. As a condition of the Amendment, we received from our financial advisor, an opinion that the Amendment is fair from a financial point of view to our equityholders. After the amendment, the B Units have the same terms as the A Units. (See Note 10.)

As of May 24, 2005, \$3,705,000 A Units and \$1,840,000 B Units were outstanding.

### **PRIVATE PLACEMENT OF UNITS**

From May 18, 2005 to May 24, 2005, the Company sold \$163,000 of equity units (the 2005 Units ) in a private placement. Each Unit consists of a convertible promissory note in the principal amount of \$1,000 (the Notes ) and one warrant for each share of common stock issued upon conversion of the Notes to purchase one-half share of Company common stock. The purchase price per Unit is \$1,000. The Notes are convertible at the election of the holder thereof, at any time commencing from and after their date of issuance and for a period of three years thereafter at a price equal to 85% of the average closing price of Company common stock on the OTC-BB for the 20 trading days immediately preceding the day upon which the Company receives a conversion notice from the Noteholder. The Notes are entitled to receive an 8% annual interest payment payable in shares of Company common stock. The per share exercise price of the warrant will be 135% of the conversion price of the Notes.

Unitholders will have the following registration rights with respect to the shares of common stock into which the Notes are convertible and warrants are exercisable. The Company will undertake to file with the SEC a registration statement covering the underlying shares of common stock on or before July 30, 2005. The Company has agreed to use its best efforts to have the registration statement declared effective within 60 days of filing. Unitholders will be subject to a lock-up on the sale of the Unitholders securities included in the registration statement until November 30, 2005.

### **CONSULTING AND EMPLOYMENT AGREEMENTS**

On April 13, 2004 the Company and the finder in the January 2004 debenture transaction and affiliated persons (collectively, the finder ) entered into an agreement to settle payments due to such finder and the finder agreed to remit all of its warrants to the Company or its designee.

On May 6, 2005, the Company entered into an agreement extending the June 1, 2004 services agreement with Bridgehead Partners from January 1, 2005 until May 31, 2005. Pursuant to the extension of the Bridgehead Partners services agreement the Company will pay a \$15,000 per month retainer and \$35,000 of the performance bonus payable under the original services agreement, and will issue five year fully vested warrants for 200,000 shares of Company common stock with an exercise price of \$0.064. As of May 6, 2005 Bridgehead Partners also vested in the second tranche (50,000 shares) of warrants from the original services agreement.

### **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

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The following discussion and analysis should be read together with the financial statements and the accompanying notes thereto included elsewhere in this Report.

The Private Securities Litigation Reform Act of 1995 provides a safe harbor for certain forward-looking statements. This report contains certain forward-looking statements and information that are based on the beliefs of management as well as assumptions made by and information currently available to management. The statements contained in this report relating to matters that are not historical facts are forward-looking statements that involve risks and uncertainties including the Company, including, but not limited to, the successful commercialization of batteries, future demand for products, general economic conditions, government and environmental regulation, competition and customer strategies, technological innovations in the battery industries, changes in business strategy or development plans, capital deployment, business disruptions, its ability to consummate future financings and other risks and uncertainties, certain of which are beyond its control. Additional factors that could affect the Company's forward-looking statements include, among other things: the restatement of the quarterly financial statements for the first three quarters in the fiscal year ended December 31, 2004; negative reactions from the Company's stockholders, creditors, customer or employees to the results of the review and restatement or delay in providing financial information caused by restatement; the impact and result of any litigation (included private litigation), or of any investigation by the Securities and Exchange Commission or any investigation by any other governmental agency related to the Company; the Company's ability to manage its operations during and after the financial statement restatement process; and the Company's ability to successfully implement internal controls and procedures that remediate any material weakness in controls and ensure timely, effective and accurate financial reporting. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may differ materially from those described herein as anticipated, believed, estimated or expected.

**GENERAL**

We are a development and pilot-line production stage company that develops large format lithium-ion rechargeable batteries to be used as a new power source for emerging applications in the national security, transportation and stationary power markets.

In 2002, we closed share exchanges in which we acquired a 100% interest in GAIA through our acquisition of 100% of the outstanding shares of GAIA Holding from Arch Hill Ventures, an entity controlled by Arch Hill Capital. In November 2004, Arch Hill Capital and Arch Hill Ventures transferred all LTC securities owned by such entities to Stichting GAIA and Stichting LTC, entities which are controlled by Arch Hill Capital.

**LIQUIDITY AND FINANCIAL CONDITION**

**GENERAL**

At March 31, 2005, cash and cash equivalents were \$1,711,000. Total liabilities at March 31, 2004 were \$25,938,000 consisting of current liabilities in the aggregate amount of \$6,958,000 and long-term liabilities in the amount of \$18,980,000. At March 31, 2005, assets included, in addition to cash and cash equivalents, accounts receivable of \$74,000 inventories of \$103,000 \$7,000 due from related parties, prepaid expenses and other current assets of \$610,000, property and equipment, net, of \$6,060,000, net intangibles of \$8,183,000, and other assets of \$530,000. As of March 31, 2005, our working capital deficit was \$4,453,000 as compared to \$3,773,000 at March 31, 2004. We expect to incur substantial operating losses as we continue our commercialization efforts.

Our long-term liabilities at March 31, 2005 were as follows:

Convertible debt securities	\$ 2,121,000
Derivative liability	5,411,000
Loans from financial institutions	1,993,000
Debentures	2,500,000
Subordinated loans from related party	6,592,000
Silent partnership loans	2,497,000
	<hr/>
	\$ 21,114,000
Less current maturities	(2,134,000)
	<hr/>
	\$ 18,980,000

See Note 8 to Financial Statements.

**FINANCING TRANSACTIONS**



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We have financed our operations since inception primarily through equity financings, loans from shareholders and other related parties, loans from silent partners and bank borrowings secured by assets. The following is a general description of our most recent financing transactions.

**BRIDGE FINANCINGS.** Arch Hill Capital and LTC entered into a bridge financing agreement in December 2001. Arch Hill Ventures and GAIA entered into a bridge financing agreement in December 2000. The proceeds of the bridge financings were used for working capital.

On April 13, 2004, pursuant to a debt exchange agreement between LTC, GAIA Holding, GAIA, Arch Hill Capital and Arch Hill Ventures, approximately \$9.7 million of debt owed by LTC to Arch Hill Capital under the bridge financing agreement and approximately \$23.2 million of debt owed by GAIA to Arch Hill Ventures under the subordinated loan agreement were exchanged for LTC debentures and equity securities. (See April 2004 Debt Exchange .)

On August 30, 2004 we issued 1,705 of our A Units in exchange for \$1,705,000 of our outstanding debt and 1,840 of our B Units in exchange for \$1,840,000 of our outstanding debt, in each case held by Arch Hill Capital. (See A Unit and B Unit Financing )

At various times during 2004, Arch Hill Capital advanced a total of \$4,000,000 to LTC under the Bridge Financing Agreement. As of December 31, 2004, these advances had been converted to April 2004 10% convertible debentures and A and B units. As of March 31, 2005, \$175,000 of advances were outstanding under the LTC Bridge Financing Agreement.

We have recently entered into a number of financing transactions and are continuing to seek other financing initiatives. We will need to raise additional capital to meet our working capital needs and to complete our product commercialization process. Such capital is expected to come from the sale of securities, including the sale of common stock under the standby equity distribution agreement described below. No assurances can be given that such financing will be available in sufficient amounts or at all. If such financing is not available there can be no assurance that Arch Hill will provide any further funding under the bridge financing agreement.

**JANUARY 2004 CONVERTIBLE DEBENTURE FINANCING.** On January 20, 2004, we entered into a securities purchase agreement with an investment group to purchase \$2,000,000 of our January 2004 debentures with attached warrants to purchase up to 1,000,000 shares of our common stock. The proceeds of the financing were used for working capital.

#### **General Description of January 2004 Debentures**

Our January 2004 debentures have a maturity date of January 20, 2006 at which time the principal amount and all accrued interest on the debentures is due and payable. Interest payments on the January 2004 debentures are due and payable in cash, or at the option of the January 2004 debenture holder, in our common stock at a price equal to the conversion price of our common stock as described below. Interest is due quarterly commencing March 31, 2004. Any amount of principal or interest on the January 2004 debentures which is not paid when due bears interest at 15% per annum from the due date of such payment default.

The January 2004 debentures are secured by a first priority security interest in all of our U.S. assets, including our goods, fixtures, equipment, inventory, contract rights, receivables and intellectual property and certain equipment of GAIA, subject to certain preexisting liens.

The January 2004 debentures are convertible at any time at the option of the holder into shares of our common stock. The conversion price of our common stock used in calculating the number of shares issuable upon conversion, or in payment of interest on the 10% debentures, is the lesser of:

50% of the average of the lowest three trading prices of our common stock for the twenty trading days ending one trading day prior to the date we receive a conversion notice from a January 2004 debenture holder; and

a fixed conversion price of \$2.00.

We have the right to prepay all or a portion of the outstanding January 2004 debentures and accrued and unpaid interest upon prior written notice to the holders of the January 2004 debentures in an amount equal to 150% of principal and interest for prepayments occurring after April 18, 2004. If we prepay all of the outstanding January 2004 debentures, we must issue an aggregate of 2.5% of our total issued and outstanding common stock to the January 2004 debenture holders on a pro rata basis.

As of March 31, 2004, \$712,850 in principal of January 2004 debentures were outstanding. As of May 24, 2005, \$24,880 in principal of January 2004 debentures were outstanding.

#### **Description of Warrants Issued in the January 2004 Debenture Financing**

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The warrants purchased by the January 2004 debenture holders entitle the January 2004 debenture holders to purchase 1,000,000 shares of our common stock at an exercise price of \$2.00 per share.

The warrants expire on January 20, 2009. The warrants are subject to exercise price adjustments upon the occurrence of certain events including stock dividends, stock splits, mergers, reclassifications of stock or our recapitalization. The exercise price of the warrants is also subject to reduction if we issue any rights, options or warrants to purchase shares of our common stock at a price less than the market price of our shares as quoted on the OTC Bulletin Board, subject to certain exceptions.

Also, if at any time, we declare a distribution or dividend to the holders of our common stock in the form of cash, indebtedness, warrants, rights or other securities, the holders of the warrants are entitled to receive the distribution or dividend as if the warrant holders had exercised the warrants.

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**Registration Rights Agreement with the January 2004 Debenture Holders**

Simultaneously with the execution of the securities purchase agreement, we entered into a registration rights agreement with the January 2004 debenture holders which entitled holders of the January 2004 debentures and attached warrants to registration of the shares underlying the January 2004 debentures, warrants and any shares issuable upon repayment of the debentures. On July 9, 2004, the registration statement we filed under the Securities Act of 1933 to register all such securities held by the January 2004 debenture holders, the warrants held by the finder in the January 2004 debenture financing and securities held by Arch Hill Capital and Arch Hill Ventures, was declared effective by the Securities and Exchange Commission.

**Finder's Warrants**

On May 5, 2004, we issued to the finder and affiliated persons in the January 2004 debenture financing warrants to purchase shares of LTC common stock pursuant to an investment banking services agreement. The warrants entitle the holders to purchase, in the aggregate, such number of shares of the common stock equal to 10% of the aggregate number of fully diluted and/or converted shares of common stock as are purchased by the January 2004 debenture holders (after giving effect to any increase in shares under a ratchet or similar provision pursuant to which the number of shares initially purchased is subsequently increased). The exercise price per share of the warrants is equal to 110% of the effective per share price paid by the January 2004 debenture holders for the securities purchased by such debenture holders. The warrants are exercisable until January 20, 2009.

As of December 31, 2004, the finder held warrants to purchase 350,000 shares of common stock at exercise prices ranging from \$0.66 to \$0.97. From January 1, 2005 to April 12, 2005, the finder was issued additional warrants to purchase 1,640,000 shares of our common stock at prices ranging from \$0.039 to \$0.084 per share. On April 13, 2005, we terminated the investment banking services agreement with the finder for a payment of \$80,000 and the finder agreed to remit all of the foregoing warrants and any additional warrants it would otherwise be entitled to under such agreement.

**APRIL 2004 DEBT EXCHANGE.** On April 13, 2004, pursuant to a debt exchange agreement, approximately \$9.7 million of debt owed by LTC to Arch Hill Capital under the Bridge Financing Agreement and approximately \$23.2 million of debt owed by GAIA to Arch Hill Ventures under the Subordinated Loan Agreement were exchanged for LTC debentures and equity securities.

Pursuant to the terms of the bridge financing agreement with Arch Hill Capital, amounts outstanding under any promissory notes issued from July 29, 2002 to December 2002 were exchangeable into debentures in the amount of such promissory notes and one warrant for each \$1.00 principal of debentures, on the same terms as the securities issued to the January 2004 debenture holders (the January 2004 Securities). Further, pursuant to the terms of the bridge financing agreement, Arch Hill Capital had the option to apply all amounts due under bridge notes issued from January 1, 2003 for 10% debentures in the amount of such promissory notes and one warrant for each \$1.00 principal of debentures, on the same terms as the January 2004 Securities. Arch Hill Capital waived its right to acquire securities having the same terms as the January 2004 Securities for all of the bridge notes issued from January 1, 2003 to April 13, 2004, other than with respect to \$1,412,625 of bridge notes issued in 2003, provided shares of our common stock and warrants were issued for such debt.

Based on the foregoing, pursuant to the debt exchange agreement:

\$1,587,375 of bridge notes held by Arch Hill Capital and issued by LTC in 2002 were exchanged for \$1,587,375 of LTC 10% Convertible Debentures Due 2006 and warrants to purchase up to 793,688 shares of LTC common stock exercisable at \$2.00 per

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share;

\$1,412,625 of bridge notes held by Arch Hill Capital and issued by LTC in 2003 were exchanged for \$1,412,625 of LTC 10% Convertible Debentures Due 2006 and warrants to purchase up to 706,312 shares of LTC common stock exercisable at \$2.00 per share;

\$5,459,502 of bridge notes issued by LTC in 2003 and \$918,159 of bridge notes issued by LTC from January 1, 2004 through April 13, 2004 and \$323,284 of interest on the bridge notes issued in 2003 and 2004 were exchanged for 6,069,697 shares of LTC common stock and warrants to purchase up to 10,500,000 shares of LTC common stock exercisable at \$2.40 per share; and

\$23,185,604 of debt owed to Arch Hill Ventures by GAIA was exchanged for 21,001,453 shares of LTC common stock.

As a condition to the closing of the debt exchange, we received from our financial advisor, an opinion that the debt exchange is fair from a financial point of view to our stockholders.

The fair market value of the shares of LTC common stock and warrants issued in the debt exchange equaled the carrying value of the debt. As a result no gain or loss was recorded on the exchange.

As of March 31, 2005 all of the April 2004 debentures were converted into common stock. (See Conversion of 10% Debentures .)

**Standstill Agreements of Arch Hill**

Arch Hill Capital and Arch Hill Ventures agreed, in connection with the sale of our January 2004 debentures, that neither they nor their affiliates would, for a period beginning January 20, 2004 and ending July 9, 2005 or such earlier date that we repay all amounts due under the January 2004 debentures or that all of the January 2004 debentures have been fully converted:

offer to sell, contract to sell, pledge, grant any rights or otherwise dispose of any shares of our common stock held by such entities without the prior consent of the January 2004 debenture holders; or

engage in any hedging transactions which are designed or reasonably expected to lead to or result in a disposition of the shares of our common stock held by such entities.

**PROVISIONS APPLICABLE TO JANUARY 2004 DEBENTURES AND APRIL 2004 DEBENTURES.** The January 2004 debentures and the April 2004 debentures (together, the 10% debentures ) include the following provision, among others.

**Covenants**

Among other covenants, 10% debentures provide that we may not, without the prior written consent of the debentures holders, do any of the following:

pay, declare or set apart for payment any dividend or other distribution on shares of our capital stock other than shares issued in the form of a stock dividend;

redeem, repurchase or otherwise acquire any shares of our capital stock or any warrants, rights or options to purchase or acquire our shares of capital stock;

sell, lease or otherwise dispose of any significant portion of our assets outside of the ordinary course of our business;

lend money, give credit or make advances to any person or entity except as in existence or committed on the date of issuance of the 10% debentures, in the ordinary course of our business or not in excess of \$50,000; or

assume, guarantee, endorse or otherwise become liable upon the obligation of any person or entity except as in existence or committed on the date of issuance of the 10% debentures, in the ordinary course of our business or not in excess of \$50,000.

The January 2004 debentures also provide that we may not without the consent of the holder of such debentures:

incur any indebtedness, except indebtedness in existence or committed on January 20, 2004 and additional borrowings from existing lenders of which we have informed the holders of the 10% debentures, indebtedness to trade creditors or financial institutions incurred in the ordinary course of our business or to repay the 10% debentures.

The securities purchase agreement and debt exchange agreement each contain a number of covenants, including the following:

we must timely permit the transfer of the 10% debentures, warrants and conversion shares which are eligible for transfer under an exemption from registration;

we must timely file all of our reports with the Securities and Exchange Commission;

we must keep at all times authorized and reserved for issuance, two times the number of shares that is actually issuable upon full conversion of the 10% debentures and exercise price of the warrants (based on the conversion price of the 10% debentures and exercise price of the warrants in effect from time to time);

we must maintain the listing of the common stock and the shares issuable upon conversion of the 10% debentures or exercise of the warrants on at least the OTC Bulletin Board (or equivalent replacement exchange), the NASDAQ National Market, the NASDAQ SmallCap Market, the New York Stock Exchange or the American Stock Exchange; and

we must maintain our corporate existence and we may not sell all or substantially all of our assets except in the event of a merger or consolidation or sale where the surviving entity assumes all of our obligations under the securities purchase agreement, the 10% debentures and related agreements and such entity is a publicly traded corporation whose stock is listed for trading on the OTC Bulletin Board, NASDAQ, the NASDAQ SmallCap Market, the New York Stock Exchange or the American Stock Exchange.

We are not in compliance with our covenant to timely file all of our reports with the Securities and Exchange Commission as a result of the late filing of this Form 10-QSB.

The securities purchase agreement also contains the following covenants:

we may not without the consent of the majority of the January 2004 debenture holders, grant any registration rights to any third party at any time prior to July 9, 2005; and

we may not without the consent of the majority of the January 2004 debenture holders, conduct any equity financing during the period ending January 9, 2007 without providing the January 2004 debenture holders with the opportunity to participate in the equity financing on the same terms and conditions offered to the potential investors.

The January 2004 debenture holders consented to the grant of registration rights to the investors who purchased our A and B Units.

In the event of a breach of any material covenant in the securities purchase agreement, we are required to pay to the January 2004 debenture holders damages in the amount of 3% of the outstanding amount of the January 2004 debentures per month of such breach plus accrued and unpaid interest on the January 2004 debentures, prorated for partial months, in cash or shares at the conversion price of the January 2004 debentures, at our option, until such breach is cured.



**Events of Default under the 10% Debenture**

If we commit an event of default under the 10% debentures, the 10% debentures will become immediately due and payable in cash and we must pay to the 10% debenture holders an amount equal to the greater of:

130% of the outstanding principal amount plus accrued interest on the 10% debentures plus default interest, if any, plus any amounts owed to the 10% debenture holders under the registration rights agreement; or

the value of the number of shares of our common stock into which the 10% debentures are convertible based upon the trading price of our common stock on the day preceding the date of payment.

In the event of default under the January 2004 debentures the holders of such debentures would also have the right to exercise their rights under the security agreements securing the January 2004 debentures which could lead to control of substantially all of our assets by the January 2004 debenture holders.

Events of default under the 10% debentures include:

our failure to pay timely any principal or interest due on the 10% debentures;

our failure or inability to issue shares of our common stock upon conversion of the 10% debentures or exercise of the attached warrants;

our breach of any of the material covenants, representations or warranties included in the 10% debentures or the related purchase agreement or registration rights agreement, as applicable;

an assignment by us for the benefit of creditors or appointment of a receiver or trustee for a substantial part of our business or property;

an unstayed judgment entered against us for more than \$100,000;

bankruptcy, insolvency, reorganization, liquidation proceedings or similar proceedings instituted by or against us or any of our subsidiaries; or

our failure to maintain the listing of our common stock on the OTC Bulletin Board (or equivalent replacement exchange), the NASDAQ National Market, the NASDAQ SmallCap Market, the New York Stock Exchange or the American Stock Exchange.

**Conversion of 10% Debentures**

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During the quarter ended March 31, 2005, \$761,050 of January 2004 debentures were converted into an aggregate of 13,600,000 shares of common stock at conversion prices ranging from \$0.0405 to \$0.0766 per share. From April 1, 2005 through May 24, 2005, \$687,970 of January 2004 debentures were converted into an aggregate of 27,300,000 shares of common stock at conversion prices ranging from \$0.0363 to \$0.0221 per share. As of May 24, 2005, \$24,880 of January 2004 debentures were outstanding.

In December 2004, \$3,000,000 of April 2004 debentures and accrued and unpaid interest were converted by the April 2004 Debentureholder into 42,619,718 shares of common stock. The April 2004 Debentureholder is entitled to acquire from us pursuant to a Notice of Conversion dated December 8, 2004 40,000,000 fully paid and nonassessable shares of our common stock pursuant to the conversion of \$3,000,000 principal amount of debentures, and 2,619,178 shares of common stock in payment of \$196,438.36 of accrued and unpaid interest on the debentures, for a total of 42,619,178 shares of common stock. Certificates for the shares must be delivered by us no later than ten days of an increase in the authorized number of shares of Company common stock subsequent to the conversion date.

**A UNIT AND B UNIT FINANCING.** During the fiscal year ended December 31, 2004, we closed on the sale of \$7,342,000 of our securities in a private placement. We closed on the sale of \$3,797,000 of our A Units for cash.

We also issued 1,705 of our A Units in exchange for \$1,705,000 of our outstanding debt and 1,840 of our B Units in exchange for \$1,840,000 of our outstanding debt, in each case held by Arch Hill Capital. The exchange was based on the terms of the bridge financing agreement between us and Arch Hill Capital, which gives Arch Hill Capital the option to apply the principal balance and all other sums due and payable under any promissory notes issued by us to it on or after January 1, 2003 against the purchase price of equity securities being sold by us in any equity financing after the date of

such notes. We believe the improvement of our balance sheet resulting from the debt exchange will make us more attractive to investors. In addition, from January 1, 2005 to January 31, 2005 we closed on the sale of 560 of our A Units for \$560,000 in cash. The proceeds of the financing were used for working capital.

On May 11, 2005, we amended the terms of the B Units to the same terms of the A Units. Prior to the Amendment, each B Unit consisted of one share of our Series B Convertible Preferred Stock, par value \$0.01 per share convertible into our common stock at \$1.80 per share, one warrant for each share of our common stock issued upon conversion of the Series B Preferred Stock each warrant to purchase one share of our common stock at an exercise price per share equal to \$2.25, and one warrant for each share of our common stock issued upon conversion of the Series B Preferred Stock, each warrant to purchase one share of our common stock at an exercise price per share equal to \$2.70. All of the B Units are held by Stichting LTC, an entity controlled by Arch Hill Capital. The Amendment is subject to the B Unitholders providing indirectly (through introducing third party investors to LTC) or directly debt or equity capital to us of not less than \$2,000,000 on or after the date of the Amendment and no later than December 31, 2005 on terms acceptable to us. In the event the capital is not provided by December 31, 2005, the Amendment shall be void on such date. As a condition of the Amendment, we received from our financial advisor, an opinion that the Amendment is fair from a financial point of view to our equityholders. After the Amendment, the B Units have the terms described below.

### **General Description of A Units and B Units**

Each A Unit as of May 11, 2005 consists of:

- (i) one share of our Series A Convertible Preferred Stock, par value \$0.01 per share (the Series A Preferred Stock ),
- (ii) one warrant for each share of our common stock issued upon conversion of the Series A Preferred Stock, each warrant to purchase ½ of a share of our common stock at an exercise price per share equal to 125% of the conversion price of the Series A Preferred Stock then in effect upon conversion of the shares of Series A Preferred Stock by the stockholder from time to time (the 125% A Warrant ), and
- (iii) one warrant for each share of our common stock issued upon conversion of the Series A Preferred Stock, each warrant to purchase ½ of a share of our common stock at an exercise price per share equal to 150% of the conversion price of the Series A Preferred Stock then in effect upon conversion of the shares of Series A Preferred Stock by the stockholder from time to time (the 150% A Warrant ).

Each B Unit as of May 11, 2005 consists of:

- (i) one share of our Series B Convertible Preferred Stock, par value \$0.01 per share (the Series B Preferred Stock ),
- (ii) one warrant for each share of our common stock issued upon conversion of the Series B Preferred Stock, each warrant to purchase ½ of a share of our common stock at an exercise price per share equal to 125% of the conversion price of the Series B Preferred Stock then in effect upon conversion of the shares of Series B Preferred Stock by the stockholder from time to time (the 125% B Warrant ), and
- (iii) one warrant for each share of our common stock issued upon conversion of the Series B Preferred Stock, each warrant to purchase one share of our common stock at an exercise price per share equal to 150% of the conversion price of the Series B Preferred Stock then in effect upon conversion of the shares of Series B Preferred Stock by the stockholder from time to time

(the 150% B Warrant ).

**Description of Preferred Stock**

The shares of Series A Preferred Stock are entitled to receive an 8% annual cumulative dividend payable in shares of our common stock and rank pari passu with the Series B Preferred Stock.

The shares of Series B Preferred Stock are entitled to receive an 8% annual cumulative dividend payable in shares of our common stock and rank pari passu with the Series A Preferred Stock.

As of the closing date of the private placement, a sufficient number of shares of Series A Preferred Stock and Series B Preferred Stock (together the Preferred Stock ) were not available for issuance under our certificate of incorporation. We have agreed to take all reasonable actions to promptly seek stockholder approval to amend our certificate of incorporation to increase the number of authorized shares of Preferred Stock to allow for the issuance of the Preferred Stock. Upon receipt of such stockholder approval, we will amend our certificate of incorporation to increase the number of authorized

shares of Preferred Stock and deliver the Preferred Stock to the investors. Pending the amendment of our certificate of incorporation to increase the number of authorized shares of Preferred Stock, the private placement investors may request that we deliver notes convertible into that number of shares of common stock into which the Preferred Stock would be convertible and on all other terms comparable to the terms of the Preferred Stock. Upon such request, we will deliver such notes to investors.

### **Conversion into Common Stock**

The shares of Series A Preferred Stock are convertible at the election of the holder thereof, at any time commencing from and after their date of issuance and for a period of three years thereafter, upon five days advance written notice to us. The conversion price is equal to 80% of the average closing price of our common stock on the OTC Bulletin Board for the 20 trading days immediately preceding the day upon which we receive a conversion notice from the Series A Preferred stockholder.

The shares of Series B Preferred Stock are convertible at the election of the holder thereof, at any time commencing from and after their date of issuance and for a period of three years thereafter, upon five days advance written notice to us. The conversion price is equal to 80% of the average closing price of our common stock on the OTC Bulletin Board for the 20 trading days immediately preceding the day upon which we receive a conversion notice from the Series B Preferred stockholder.

During the period January 1, 2005 to March 31, 2005, the holders of 5,500 A Units exchanged the Series A Preferred Stock rights into \$550,000 principal of promissory notes convertible into that number of shares of common stock into which the Series A Preferred Stock would be convertible and have converted \$550,000 of such notes into an aggregate of 4,227,953 shares of Company common stock at conversion prices ranging from \$0.12 to \$0.18 per share.

From April 1, 2005 to May 24, 2005, the holders of 1,715 A Units exchanged the Series A Preferred Stock rights into \$1,715,000 principal of promissory notes convertible into that number of shares of common stock into which the Series A Preferred Stock would be convertible. The holders of \$20,000 of notes converted notes into an aggregate of 400,000 shares of Company common stock at a conversion price of \$0.05 per share and the holders of 1,840 B Units exchanged the Series B Preferred Stock rights into \$1,840,000 principal of promissory notes convertible into that number of shares of common stock into which the Series B Preferred Stock would be convertible.

### **Description of Warrants**

The 125% A Warrants and 150% A Warrants are exercisable for shares of our common stock at any time beginning on the date of conversion of the Series A Preferred Stock and ending on the fourth anniversary of their issuance. The 125% B Warrants and 150% B Warrants are exercisable for shares of our common stock at any time beginning on the date of conversion of the Series B Preferred Stock and ending on the fourth anniversary of their issuance. The 125% A Warrants, 150% A Warrants, 125% B Warrants and 150% B Warrants are subject to adjustment for anti-dilution purposes.

As of March 31, 2005, the 125% A Warrants were exercisable for 7,607,349 shares at exercise prices ranging from \$0.015 to \$0.2875, the 150% A Warrants were exercisable for 7,607,349 shares at exercise prices ranging from \$0.18 to \$0.345 and no 125% B Warrants or 150% B Warrants were exercisable.

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As of May 24, 2005, the 125% A Warrants were exercisable for 7,807,349 shares at exercise prices ranging from \$0.0625 to \$0.2875, the 150% A Warrants were exercisable for 7,807,349 shares at exercise prices ranging from \$0.075 to \$0.345 and no 125% B Warrants or 150% B Warrants were exercisable.

The broker-dealer in the A and B Unit Financing is entitled to receive as additional commission warrants to purchase that number of shares of our common stock as equals 10% of the number of shares of common stock that would be issuable to investors in the offering assuming conversion of the Series A and Series B Preferred Stock at the closing date, with an exercise price equal to 110% of their conversion prices on such date, a term of four years and all other terms substantially the same as those of other warrants issuable to investors in the offering. As of March 31, 2005, the broker dealer was entitled to warrants to purchase 948,838 shares of our common stock at prices ranging from \$0.165 to \$0.693 per share.

### **Registration Rights**

The Series A Preferred Stock, the 125% A Warrants, the 150% A Warrants, the Series B Preferred Stock, the 125% B Warrants and 150% B Warrants (and the underlying conversion and warrant shares) constitute restricted securities and may be sold only upon registration under the Securities Act or upon reliance on an exemption from such registration requirements. Series A and Series B holders have registration rights with respect to the shares of common stock into which

the Series A Preferred Stock, the 125% A Warrants, the 150% A Warrants, the Series B Preferred Stock, the 125% B Warrants and 150% B Warrants are exercisable. We have agreed to undertake to file with the Securities and Exchange Commission a registration statement covering the underlying shares of common stock at the our expense commencing 180 days following the last date of sale of the A and B Units. We have agreed to use our best efforts to have the registration statement declared effective within 60 days of the filing of the registration statement. We expect to file such registration statement during the latter part of the second fiscal quarter of 2005.

**STANDBY EQUITY DISTRIBUTION AGREEMENT.** On March 11, 2005, we entered into a standby equity distribution agreement with Cornell Capital Partners, LP pursuant to which we may, at our discretion, periodically sell to Cornell Capital shares of our common stock for a total purchase price of up to \$15,000,000. For each share of common stock purchased under the standby equity distribution agreement, Cornell Capital will pay us 98% of the lowest volume weighted average price of our common stock as quoted by on the Over-the-Counter Bulletin Board or other principal market on which our common stock is traded for the five days immediately following the date we deliver a notice requiring Cornell Capital to purchase our shares under the standby equity distribution agreement. The volume weighted average price is calculated automatically by Bloomberg L.P., a reporting service, and is calculated by multiplying the number of our shares sold on a given day by the actual sales prices and adding up the totals. Cornell Capital is a private limited partnership whose business operations are conducted through its general partner, Yorkville Advisors Management, LLC. Further, Cornell Capital will retain a fee of 5% of each advance under the standby equity distribution agreement. In addition, we engaged Newbridge Securities Corporation, a registered broker-dealer, to advise us in connection with the standby equity distribution agreement. For its services, Newbridge received a fee of 66,667 shares of our common stock. In connection with the standby equity distribution agreement, Cornell Capital received a commitment fee of 2,922,078 shares of our common stock.

Pursuant to the standby equity distribution agreement, we may periodically sell shares of common stock to Cornell Capital to raise capital to fund our working capital needs. The periodic sale of shares is known as an advance. We may request an advance every five trading days. A closing will be held one trading day after the end of each pricing period at which time we will deliver shares of common stock and Cornell Capital will pay the advance amount requested by us.

We may request advances under the standby equity distribution agreement once the underlying shares are registered with the SEC. Thereafter, we may continue to request advances until Cornell Capital has advanced \$15.0 million or 24 months after the effective date of the registration statement, whichever occurs first.

The amount of each advance is limited to a maximum draw down of \$200,000 every five trading days and the aggregate amount of advances may not exceed \$800,000 in any 30-day period. The amount available under the standby equity distribution agreement is not dependent on the price or volume of our common stock. Our ability to request advances is conditioned upon us registering the shares of common stock with the SEC. In addition, we may not request advances if the shares to be issued in connection with such advances would result in Cornell Capital owning more than 9.9% of our outstanding common stock. As of the date hereof, we have not filed the Cornell Capital Partner's registration statement. We expect to file such registration statement during the second fiscal quarter of 2005.

There are certain conditions to our right to request an advance. These conditions include:

maintaining our authorization for quotation on the OTC-BB;

having an effective registration statement related to the stock to be issued;

the absence of a stop order or other action adversely affecting the registration statement;

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no events shall have occurred that would require us to file a post-effective amendment to the effective registration statement; and

the advance will not cause Cornell Capital to beneficially own more than 9.9% of our outstanding common stock.

Cornell Capital is permitted to terminate the standby equity distribution agreement if (i) there is a stop order or suspension of the effectiveness of the registration statement for 50 trading days or (ii) we fail to materially comply with certain covenants, which include the following:

maintaining a quotation of the common stock on the OTC-BB;

maintaining our status as public company under Section 12(g) of the Exchange Act;



delivering instructions to the transfer agent to issue shares in connection with an advance notice;

notifying Cornell Capital of events impacting the registration of the stock to be issued, including the issuance of a stop order;

issuing stock or convertible securities at a price not less than the market price of our common stock on the date of issuance except as otherwise permitted by the standby equity distribution agreement; and

not merging or consolidating us with another company where the acquiring entity does not assume our obligations under the standby equity distribution agreement.

We cannot predict the actual number of shares of common stock that will be issued pursuant to the standby equity distribution agreement, in part, because the purchase price of the shares will fluctuate based on prevailing market conditions and we have not determined the total amount of advances we intend to draw. Furthermore, we have not determined the total amount of the advances we intend to draw. Nonetheless, we can estimate the number of shares of our common stock that will be issued using certain assumptions. Assuming we issue shares of common stock being at a price of \$0.15 per share and draw down on the entire standby equity distribution agreement, we would issue 100,000,000 shares of common stock to Cornell Capital for gross proceeds of \$15.0 million. These shares would represent approximately 50% of our currently outstanding common stock upon issuance, assuming no other shares were issued. As of May 24, 2005, we have not filed the registration statement registering the shares issuable under the standby equity distribution agreement and no shares have been issued under such agreement.

**MARCH 2005 DEBENTURE FINANCING.** On March 11, 2005, we entered into a debenture purchase agreement with an investor, pursuant to which we issued debentures in the principal amount of \$2,500,000. The debentures accrue interest at 12% per year and are repayable in 10 equal monthly installments with accrued interest commencing July 15, 2005 and ending April 15, 2006. The debentures contain a provision that in the event that the holder elects to waive the conversion feature of the debentures by April 15, 2005, the maturity and amortization of the debentures will be amended such that the debentures will be repaid in 10 equal monthly installments with accrued interest commencing July 15, 2005. The investor waived the conversion feature immediately prior to the closing of the transaction.

In connection with the debenture purchase agreement, we entered into an escrow agreement under which put notices under the standby equity distribution agreement were deposited and certain monies received under that agreement will be received and forwarded to the debentureholder. Ten monthly put notices are held in escrow, each in the amount of \$250,000 commencing July 2005 and ending April 2006. \$250,000 per month being funded under the standby equity distribution agreement to us is to be delivered to the escrow account and be used to repay the debenture if we do not repay the debenture from other sources of capital.

**2005 UNIT FINANCING.** From May 18, 2005 to May 23, 2005, we sold \$163,000 of equity units (the 2005 Units ) in a private placement. Each Unit consists of a convertible promissory note in the principal amount of \$1,000 (the Notes ) and one warrant for each share of common stock issued upon conversion of the Notes to purchase one-half share of our common stock. The purchase price per Unit is \$1,000. The Notes are convertible at the election of the holder thereof, at any time commencing from and after their date of issuance and for a period of three years thereafter at a price equal to 85% of the average closing price of our common stock on the OTC-BB for the 20 trading days immediately preceding the day upon which we receive a conversion notice from the Noteholder. The Notes are entitled to receive an 8% annual interest payment payable in shares of our common stock. The per share exercise price of the warrant will be 135% of the conversion price of the Notes.

The Notes are convertible at the election of the holder thereof, at any time commencing from and after their date of issuance and for a period of three years thereafter. The conversion price is equal to 85% of the average closing price of our common stock on the OTC Bulletin Board for the 20 trading days immediately preceding the day upon which we receive a conversion notice from the Noteholder. The shares of Notes are entitled to receive 8% annual interest payable in shares of our common stock. The Warrants are exercisable for shares of our common stock at any time beginning on the date of conversion of the Notes and ending on June 1, 2009 and are subject to adjustment for anti-dilution purposes.

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For the \$96,000 of Units sold on May 18, 2005, the total offering price and the total commissions paid to broker-dealers were \$96,000 and \$16,500, respectively. For the \$67,000 of Units sold on May 23, 2005, the total offering price and the total commissions paid to broker-dealers were \$67,000 and \$10,050, respectively. Broker-dealer commissions consisted of:

a commission of 12% of the gross offering proceeds raised by the broker-dealer;

a non-accountable expense allowance of 3% of the gross offering proceeds raised by the broker-dealer;

warrants to purchase that number of shares of our common stock as equals 10% of the number of shares of common stock that would be issuable to investors in the offering assuming conversion of the Notes at the closing date, with an exercise price equal to 110% of their conversion prices on such date, a term of four years and all other terms substantially the same as those of other warrants issuable to investors in the offering; and

legal fees of the broker-dealer for the offering of \$2,100.

Such fees were deducted from offering proceeds to the extent applicable.

Issuance of the securities was exempt from registration pursuant to Rule 506 of Regulation D promulgated under Section 4(2) of the Securities Act. The Units were sold to accredited investors in a private placement without the use of any form of general solicitation or advertising. The underlying securities are restricted securities subject to applicable limitations on resale.

Unitholders will have the following registration rights with respect to the shares of common stock into which the Notes are convertible and warrants are exercisable. We will undertake to file with the SEC a registration statement covering the underlying shares of common stock at our expense on or before July 30, 2005. We will use our best efforts to have the registration statement declared effective within 60 days of filing. Unitholders will be subject to a lock-up on the sale of the Unitholders securities included in the registration statement until November 30, 2005.

### **GOING CONCERN MATTERS**

Our accompanying consolidated financial statements have been prepared on a going concern basis, which contemplates the continuation of operations, realization of assets and liquidation of liabilities in the ordinary course of business. Since inception, we have incurred substantial operating losses and expect to incur additional operating losses over the next several years. As of March 31, 2005, we had an accumulated deficit of approximately \$61.6 million. We have financed our operations since inception primarily through equity financings, loans from shareholders and other related parties, loans from silent partners and bank borrowings secured by assets. We have recently entered into a number of financing transactions and are continuing to seek other financing initiatives. We will need to raise additional capital to meet our working capital needs and to complete our product commercialization process. Such capital is expected to come from the sale of securities, including the sale of common stock under the standby equity distribution agreement. No assurances can be given that such financing will be available in sufficient amounts or at all. Continuing of our operations in 2005 is dependent upon obtaining such further financing. These conditions raise substantial doubt about our ability to continue as a going concern. The accompanying consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

## **MANAGEMENT'S PLANS TO OVERCOME OPERATING AND LIQUIDITY DIFFICULTIES**

Over the past four years, we have refocused our unique extrusion-based manufacturing process, cell technology, large battery assembly expertise, and market activities to concentrate on large-format, high rate battery applications. Our commercialization efforts are focused on applying our lithium-ion rechargeable batteries in the national security, transportation and stationary power markets.

Our operations have been financed primarily through the use of proceeds from equity financings, loans, including loans from Arch Hill Capital, Arch Hill Ventures and other related parties, loans from silent partners and bank borrowings secured by assets.

Our operating plan seeks to minimize our capital requirements, but expansion of our production capacity to meet increasing sales and refinement of our manufacturing process and equipment will require additional capital. We expect that operating and production expenses will increase significantly as we continue to ramp up our production and continue our battery technology and develop, produce, sell and license products for commercial applications.

We have recently entered into a number of financing transactions and are continuing to seek other financing initiatives. We will need to raise additional capital to meet our working capital needs and to complete our product commercialization process. Such capital is expected to come from the sale of securities, including the sale of common stock under the standby equity distribution agreement. We believe that if we raise approximately \$10 to 11 million in debt and equity financings including under the standby equity distribution agreement, we would have sufficient funds to meet our operating and capital expenditures needs for at least twelve months. If we do not raise such additional capital, we will assess all available alternatives including a sale of our assets or merger, the suspension of operations and possibly liquidation, auction, bankruptcy, or other measures.

Except as described herein, we have not entered into any definitive agreements related to a new financing as of May 24, 2005, and no assurance can be given that we will be successful in completing these or any other financings at the minimum level necessary to fund our capital equipment requirements, current operations or at all. If we are unsuccessful in completing these financings at such minimum level, we will not be able to fund our capital equipment requirements or current expenses or execute our business plan. If we are unsuccessful in completing these financings at or near the maximum level or an additional financing, we will not be able to pursue our business strategy. Additional financing may not be available on terms favorable to us or at all. Even if we do obtain financing, it may result in dilution to our stockholders.

## **RESULTS OF OPERATIONS**

### **THREE MONTHS ENDED MARCH 31, 2005 COMPARED TO**

### **THREE MONTHS ENDED MARCH 31, 2004**

**REVENUES FROM DEVELOPMENT CONTRACTS AND PROTOTYPE SALES** increased by \$55,000 or 63% in the three months ended March 31, 2005 from \$87,000 in the same period in 2004. We also had income from foreign government subsidiaries of \$1,000 in 2005 compared to \$141,000 in 2004. The increase in revenues from development contracts and prototypes sales and decrease in income from foreign government subsidiaries is a result of our movement in 2004 from the product and process development and refinement stage to the early production stage of our products.

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**ENGINEERING, RESEARCH AND DEVELOPMENT EXPENSES** during the three months ended March 31, 2005 increased by 30% to \$1,570,000 from \$1,211,000 in the same period in 2004. These increases resulted primarily from advancement of technology in large high rate battery applications. These increases include expenses related to material consumed in the continued refinement of production process, as well as increased engineering and development time dedicated to advancement of manufacturing processes as well as time associated with the installation of new production equipment.

**GENERAL AND ADMINISTRATIVE EXPENSES** during the three months ended March 31, 2005 increased by \$111,000 or approximately 11% to \$1,120,000 from \$1,009,000 in the same period in 2004. This increase was primarily due to increased legal and consulting expenses related to securities offerings and debt exchanges.

**DEPRECIATION AND AMORTIZATION** during the three months ended March 31, 2005 increased by \$42,000 or 10% to \$450,000 from \$408,000 in the same period in 2004. The increase was primarily due to the depreciation on property and equipment purchased during 2004 and amortization of securities issue costs.

**INTEREST EXPENSE, NET OF INTEREST INCOME**, for the three months ended March 31, 2005 increased by \$646,000 or 70% to \$1,573,000 from \$927,000 in the same period in 2004. Interest expense increased as a result of interest accrued on the loans from Arch Hill Capital and Arch Hill Ventures and the interest accrued on the January 2004 debentures and the April 2004 debentures. In addition, the January 2004 and April 2004 10% convertible debentures contain a variable conversion feature, which was determined to be an embedded derivative under FASB 133. The value of this embedded derivative resulted in discounts of \$2,000,000 and \$3,000,000 on the January 2004 and April 2004 debentures, respectively, which is being amortized over the lives of the debentures, and charged to interest expense. Only the January 2004 debentures were outstanding during the three months ended March 31, 2004.

**CHARGE FOR EMBEDDED DERIVATIVE AND WARRANTS PREFERRED SHARES AND DIVIDENDS ON PREFERRED SHARES** were \$845,000 and \$113,000, respectively, in the three months ended March 31, 2005. There were no private placement units outstanding in the three months ended March 31, 2004.

**NET LOSS TO COMMON SHAREHOLDERS** \$5,528,000 or \$(0.09) per share for the three months ended March 31, 2005 as compared to a net loss of \$3,327,000 or \$(0.31) for the three months ended March 31, 2004. The increase in net loss for the quarter was principally due to the increase in interest expense on outstanding debt and the interest expense related to the debentures issued in January and April 2004, the charge for the embedded derivative related to the preferred shares and warrants and dividends on the convertible preferred shares.

**ACCUMULATED DEFICIT.** Since inception, we have incurred substantial operating losses and expect to incur substantial additional operating losses over the next several years. As of March 31, 2005, our accumulated deficit was \$61,638,000.

### **CRITICAL ACCOUNTING POLICIES**

The Securities and Exchange Commission ( SEC ) defines critical accounting policies as those that require application of management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain and may change in subsequent periods. Our significant accounting policies are described in Note 3 in the Notes to the Consolidated Financial Statements. Not all of these significant accounting policies require management to make difficult, subjective or complex judgments or estimates. However, the following policies could be deemed to be critical within the SEC definition.

### **REVENUES**

We perform certain research and development for other companies and sell prototypes to third parties. Revenue is recognized as services are rendered or products are delivered, the price to the buyer is fixed and determinable, and collectibility is reasonably assured.

### **USEFUL LIVES OF TANGIBLE AND INTANGIBLE ASSETS**

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Depreciation and amortization of tangible and intangible assets are based on estimates of the useful lives of the assets. We regularly review the useful life estimates established to determine their propriety. Changes in estimated useful lives could result in increased depreciation or amortization expense in the period of the change in estimate and in future periods that could materially impact our financial condition and results of operations.

### **IMPAIRMENT OF LONG-LIVED ASSETS**

Effective January 1, 2002, we adopted Statement of Financial Accounting Standards ( SFAS ) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets ( SFAS No. 144 ). SFAS No. 144 requires that long-lived assets and certain identifiable intangibles be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. An impairment charge could materially impact our financial condition and results of operations.

## **INCOME TAXES**

As part of the process of preparing our consolidated financial statements, we are required to estimate our taxes in each of the jurisdictions of operation. This process involves management estimating the actual current tax expense together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within the consolidated balance sheet. We then must assess the likelihood that the deferred tax assets will be recovered from future taxable income and, to the extent recovery is not likely, we must establish a valuation allowance. Future taxable income depends on the ability to generate income in excess of allowable deductions. Significant management judgment is required in determining the provision for income taxes, deferred tax assets and liabilities and any valuation allowance recorded against net deferred tax assets. In the event that actual results differ from these estimates or we adjust these estimates in future periods, we may need to change our valuation allowance that could materially impact our financial condition and results of operations.

## **FAIR VALUE OF FINANCIAL INSTRUMENTS**

Fair value estimates, assumptions and methods used to estimate fair value of our financial instruments are made in accordance with the requirements of SFAS No. 107, Disclosures about Fair Value of Financial Instruments. We have used available information to derive our estimates. However, because these estimates are made as of a specific point in time, they are not necessarily indicative of amounts we could realize currently. The use of different assumptions or estimating methods may have a material effect on the estimated fair value amounts.

## **RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS**

On December 16, 2004, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 123(R), Share-Based Payment , which is a revision of SFAS No. 123 and supersedes APB Opinion 25. SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be valued at fair value on the date of grant, and to be expensed over the applicable vesting period. Pro forma disclosure of the income statement effects of share-based payments is no longer an alternative. SFAS No. 123(R) is effective for all stock-based awards granted on or after January 1, 2006 . In addition, companies must also recognize compensation expense related to any awards that are not fully vested as of the effective date. Compensation expense for the unvested awards will be measured based on the fair value of the awards previously calculated in developing the pro forma disclosures in accordance with the provisions of SFAS No. 123.

The Company plans to adopt SFAS No. 123(R) on January 1, 2006. This change in accounting is not expected to materially impact our results of operations. We have not completed the calculation of this impact. However, because we currently account for share-based payments to our employees using the intrinsic value method, our results of operations have not included the recognition of compensation expense for the issuance of stock option awards.

On December 16, 2004, the FASB issued SFAS No. 153, Exchanges of Nonmonetary Assets , which is an amendment to APB Opinion No. 29. It states that the exchanges on nonmonetary assets should be measured based on the fair value of the assets exchanged. Further, FSAS No. 153 eliminates the narrow exception for nonmonetary exchanges of similar productive assets and replaces it with a broader exception for exchanges of nonmonetary assets that do not have commercial substance . SFAS No. 153 is effective for financial statements for fiscal years beginning after June 15, 2005. Earlier application is permitted for nonmonetary asset exchanges incurred during fiscal years beginning after the date that this statement is issued. Management believes the adoption of this Statement will not have an effect on the consolidated financial statements.

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On November 24, 2004, FASB issued SFAS No. 151, *Inventory Costs*, which is an amendment to ARB No. 43, Chapter 4. It clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). The FASB states that these costs should be expensed as incurred and not included in overhead. Further, SFAS No. 151 requires that allocation of fixed production overheads to conversion costs should be based on normal capacity of the production facilities. SFAS No. 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. Management believes the adoption of this Statement will not have an effect on the consolidated financial statements.

In December 2003, the FASB issued FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*. ( VIEs ) ( FIN 46R ) which addresses how a business enterprise should evaluate whether it has a controlling financial interest in an entity through means other than voting rights and accordingly should consolidate the entity. FIN 46R replaces FASB Interpretation No. 46. *Consolidation of Variable Interest Entities*, which was issued in January 2003. The Company has adopted FIN 46R as of March 31, 2004 for variable interests in VIEs. For any VIEs that must be consolidated under FIN 46R that were created before January 1, 2004, the assets, liabilities and noncontrolling interests of the VIE initially would be measured at their carrying amounts with any difference between the net amount added to the balance sheet and any previously recognized interest being recognized as the cumulative effect of an



accounting change. If determining the carrying amounts is not practicable, fair value at the date FIN 46R first applies may be used to measure the assets, liabilities and noncontrolling interest of the VIE. The adoption of FIN 46R did not have an effect on the consolidated financial statements inasmuch as the Company has no interests in any VIEs.

### **RISK FACTORS AFFECTING OUR COMPANY**

Investors should carefully consider the following risk factors, in addition to the other information concerning the factors affecting forward-looking statements. Each of the risk factors could adversely affect business, operating results and financial condition as well as adversely affect the value of an investment in us.

### **FINANCIAL CONDITION RISKS**

**WE HAVE SUBSTANTIAL INDEBTEDNESS AND ARE HIGHLY LEVERAGED.** At March 31, 2005, we had total consolidated long-term indebtedness of approximately \$19.0 million, plus current portion of approximately \$2,134,000, and a stockholders' deficit of approximately \$61.6 million. We also had at March 31, 2005, current liabilities of approximately \$7.0 million.

The level of our indebtedness and related debt service requirements could negatively impact our ability to obtain any necessary financing in the future for working capital, capital expenditures or other purposes. A substantial portion of our future cash flow from operations, if any, may be dedicated to the payment of principal and interest on our indebtedness. Our high leverage may also limit our flexibility to react to changes in business and may place us at a competitive disadvantage to less highly leveraged competitors. In addition, creditors who remain unpaid may initiate collection proceedings, which could hamper our operations due to our short term cash needs or the effect on our assets subject to debt.

**WE HAVE A HISTORY OF OPERATING LOSSES AND HAVE BEEN UNPROFITABLE SINCE INCEPTION.** We incurred net losses of approximately \$61.4 million from February 12, 1999 (date of inception) to March 31, 2005, including approximately \$5.5 million of net loss to common shareholders in the quarter ended March 31, 2005. We expect to incur substantial additional operating losses in the future. We have a total accumulated deficit of approximately \$61.6 million. During the quarters ended March 31, 2005 and 2004, we generated revenues from development contracts and prototype sales in the amounts of \$142,000 and \$87,000, respectively. We cannot assure you that we will continue to generate revenues from operations or achieve profitability in the near future or at all.

**WE NEED SIGNIFICANT FINANCING TO CONTINUE TO DEVELOP AND COMMERCIALIZE OUR TECHNOLOGY.** We have recently entered into a number of financing transactions and are continuing to seek other financing initiatives. We will need to raise additional capital to meet our working capital needs and to complete our product commercialization process. Such capital is expected to come from the sale of securities, including the sale of common stock under the standby equity distribution agreement. We believe that if we raise approximately \$10 to 11 million in debt and equity financings including under the standby equity distribution agreement, we would have sufficient funds to meet our operating and capital expenditures needs for at least twelve months. If we do not raise such additional capital, we will assess all available alternatives including a sale of our assets or merger, the suspension of operations and possibly liquidation, auction, bankruptcy, or other measures.

Except as described herein, we have not entered into any definitive agreements related to a new financing as of May 24, 2005, and no assurance can be given that we will be successful in completing these or any other financings at the minimum level necessary to fund our capital equipment requirements, current operations or at all. If we are unsuccessful in completing these financings at such minimum level, we will not be able to fund our capital equipment requirements or current expenses or execute our business plan. If we are unsuccessful in completing these

financings at or near the maximum level or an additional financing, we will not be able to pursue our business strategy. Additional financing may not be available on terms favorable to us or at all. Even if we do obtain financing, it may result in dilution to our stockholders. Even if we do obtain financing, it may result in dilution to our stockholders.

### **RISKS RELATED TO OUR OPERATIONS**

WE HAVE NOT PRODUCED COMMERCIAL QUANTITIES OF LITHIUM-ION BATTERIES. Our construction of large batteries for military, transportation and stationary power applications requires customized, tailored solutions for each application. At present, we operate a pilot production line that produces limited quantities of advanced rechargeable batteries for OEM sampling and initial product runs. To be successful, we must ultimately produce our lithium-ion batteries (i) in large commercial quantities; (ii) at competitive costs; (iii) with appropriate performance characteristics; and (iv) with low failure rates. We currently have no high volume manufacturing capability or experience in

large scale manufacturing of our advanced rechargeable batteries. We have limited experience in automated battery assembly and packaging technology. We cannot give assurance that we will be able to produce commercial lithium-ion batteries on a timely basis, at an acceptable cost or in the necessary commercial specifications or quantities.

**COMPETITION IN THE RECHARGEABLE BATTERY INDUSTRY IS INTENSE.** The rechargeable battery industry consists of major domestic and international companies, many of which have financial, technical, manufacturing, distribution, marketing, sales and other resources substantially greater than ours. We compete against companies producing lithium batteries as well as other primary and rechargeable battery technologies. Further, our competitors may introduce emerging technologies or refine existing technologies which could compete with our products and have a significant negative impact on our business and financial condition.

**MARKET ACCEPTANCE OF OUR BATTERIES IS UNCERTAIN.** We cannot assure you that any commercial lithium-ion batteries we are able to produce will achieve market acceptance. Market acceptance will depend on a number of factors, including:

our ability to keep production costs low. Other advanced battery chemistries may be produced at a reduced cost. As we work to reduce the cost of our batteries, we expect that manufacturers of other advanced battery chemistries will do the same.

lithium-ion battery life in high rate applications. While initial testing is promising, it is difficult to predict the life of lithium-ion batteries in high rate applications. If our batteries do not last long enough when used for high rate applications, it is unlikely that there will be market acceptance of our battery products.

timely introductions of new products. Our introduction of new products will be subject to the inherent risks of unforeseen problems and delays. Delays in product availability may negatively affect their market acceptance.

**OUR BATTERY TECHNOLOGY MAY BECOME OBSOLETE.** The market for our rechargeable batteries is characterized by changing technology and evolving industry standards, often resulting in product obsolescence or short product lifecycles. Changes in end-user requirements and new products introductions and enhancements by our competitors may also render our technology obsolete. Our success will depend upon our ability to introduce in a timely manner products whose performance will match or better our competitors' products. There can be no assurance that our competitors will not develop technologies or products that would render our technology and products obsolete or less marketable.

**OUR BUSINESS STRATEGY DEPENDS ON THE CONTINUED GROWTH OF THE LITHIUM BATTERY INDUSTRY.** We would be adversely affected if sales of rechargeable lithium batteries do not continue to grow. The growth in sales of rechargeable lithium batteries may be inhibited for any number of reasons, including:

competition from other battery chemistries;

the failure of large-scale commercial production of lithium battery powered HEVs;

a significant downturn in military activities requiring rechargeable power sources; or

the failure of the markets to accept the use of lithium batteries in large-scale applications, such as energy storage.

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**WE MAY NOT BE ABLE TO ACCOMMODATE INCREASED DEMAND FOR OUR BATTERIES.** Rapid growth of our business may significantly strain our management, operations and technical resources. If we are successful in obtaining orders for commercial production of our batteries, we will be required to deliver large volumes of quality products to our customers on a timely basis and at a reasonable cost. We cannot assure you that we will obtain commercial scale orders for our batteries or that we will be able to satisfy commercial scale production requirements on a timely and cost-effective basis. As our business grows, we will also be required to continue to improve our operations, management and financial systems and controls. Our failure to manage our growth effectively could have an adverse effect on our ability to produce products and meet the demands of our customers.

**CERTAIN COMPONENTS OF OUR BATTERIES POSE SAFETY RISKS THAT MAY CAUSE ACCIDENTS IN OUR FACILITIES AND IN THE USE OF OUR PRODUCTS.** As with any battery, our lithium-ion batteries can short circuit when not handled properly. Due to the high energy and power density of lithium-ion batteries, a short circuit can cause rapid heat buildup. Under extreme circumstances, this could cause a fire. This is most likely to occur during the

formation or testing phase of our process. While we incorporate safety procedures in our battery testing lab to minimize safety risks, we cannot assure you that an accident in any part of our facilities where charged batteries are handled will not occur. Any such accident could result in injury to our employees or damage to our facility and would require an internal investigation by our technical staff. Any such injuries, damages or investigations could lead to liability to our company and cause delays in further development and manufacturing of our product which could adversely affect our operations and financial condition.

Our manufacturing process incorporates pulverized solids, which can be toxic to employees when allowed to become airborne in high concentrations. We have incorporated safety controls and procedures into our pilot line manufacturing processes designed to maximize the safety of our employees and neighbors. Any related incident, including fire or personnel exposure to toxic substances, could result in significant production delays or claims for damages resulting from injuries, which could adversely affect our operations and financial condition.

**WE MUST COMPLY WITH EXTENSIVE REGULATIONS GOVERNING SHIPMENT OF OUR BATTERIES AND OPERATION OF OUR FACILITY.** We are subject to the U.S. Department of Transportation (USDOT) and the International Transport Association (IATA) regulations regarding shipment of lithium-ion batteries. Due to the size of our prototype HEV batteries, a permit is required to transport our lithium batteries from our manufacturing facility. Although similar batteries with other chemistries are routinely shipped from manufacturing facilities to all parts of the world, we cannot assure you that we will not encounter any difficulties in obtaining shipment permits or in complying with new or amended regulations regarding shipment of our products.

**WE COULD INCUR SIGNIFICANT COSTS FOR VIOLATIONS OF OR TO COMPLY WITH APPLICABLE ENVIRONMENTAL AND OCCUPATIONAL HEALTH AND SAFETY LAWS AND REGULATIONS.** National, state, local and foreign laws impose various environmental controls on the manufacture, storage, use and disposal of lithium batteries and of certain chemicals used in the manufacture of lithium batteries. Although we believe that our operations are in substantial compliance with current environmental regulations and that there are no environmental conditions that will require material expenditures for clean-up at our facility or at facilities to which we have sent waste for disposal, we cannot assure you that new laws or regulations or changes in existing laws or regulations will not impose costly compliance requirements on us or otherwise subject us to future liabilities. Moreover, foreign, state and local governments may enact additional restrictions relating to the disposal of lithium batteries used by our customers which could require us to respond to those restrictions or could negatively affect the demand for those batteries.

As with all employers in the U.S., we must comply with U.S. Occupational and Safety Administration (OSHA) regulations designed for the protection of employees while at the workplace. We are also subject to U.S. Environmental Protection Agency (USEPA) and Pennsylvania Department of Environmental Protection Agency (PADEP) regulations designed to protect the environment from contaminants that can be discharged from manufacturing facilities. We cannot assure you that we will not incur significant expenses or encounter any difficulties in complying with OSHA, USEPA, and PADEP regulations.

**OUR BUSINESS AND GROWTH WILL SUFFER IF WE ARE UNABLE TO RETAIN KEY PERSONNEL.** Our success depends in large part upon the services of a number of key employees and senior management. If we lose the services of one or more of our key employees or senior management, it could have a significant negative impact on our business.

**WE CANNOT GUARANTEE THE PROTECTION OF OUR TECHNOLOGY OR PREVENT THE DEVELOPMENT OF SIMILAR TECHNOLOGY BY OUR COMPETITORS.** Our success depends largely on the knowledge, ability, experience and technological expertise of our employees rather than on the legal protection of our patents and other proprietary rights. We claim proprietary rights in various unpatented technologies, know-how, trade secrets and trademarks relating to our products and manufacturing processes. We cannot guarantee the adequacy of protection these claims afford, or that our competitors will not independently develop or patent technologies that are substantially equivalent or superior to our technology. We protect our proprietary rights in our products and operations through contractual obligations, including nondisclosure agreements, with our employees and consultants. We cannot guarantee the adequacy of protection these contractual measures afford.

We have patents issued and patent applications pending in the U.S., Europe and elsewhere. We cannot assure you (i) that patents will be issued from any pending applications, (ii) that the claims allowed under any patents will be sufficiently broad to protect our technology, (iii) that any patents issued to us will not be challenged, invalidated or circumvented, or (iv) as to the adequacy of protection any patents or patent applications afford.

If we are found to be infringing upon third party patents, we cannot assure you that we will be able to obtain licenses with respect to such patents on acceptable terms, if at all. Our failure to obtain necessary licenses could lead to costly attempts to design around such patents or delay or even foreclose the development, manufacture or sale of our products.

**WE MAY FACE LIABILITY IF OUR BATTERIES FAIL TO FUNCTION PROPERLY.** We maintain liability insurance coverage that we believe is sufficient to protect us against potential claims. We cannot assure you that our liability insurance will continue to be available to us on its current terms or at all, or that such liability insurance will be sufficient to cover any claim or claims.

**WE FACE RISKS RELATED TO OUR ACCOUNTING RESTATEMENTS.** On May 10, 2005 we publicly announced that we had discovered accounting inaccuracies in previously reported financial statements. Following consultation with our auditors, we have decided to restate our financial statements for the quarters ended March 31, 2004, June 30, 2004 and September 30, 2004. The restatements relate to a correction to certain errors relating to the accounting for certain of our financing transactions in 2004. While all of these transactions were recorded, BDO Seidman, LLP in their audit work noted instances where generally accepted accounting principles were not correctly applied and adjustments to our financial statements were required. The correction relates solely to the accounting treatment of these financing transactions and does not affect our historical cash flow. The restatement relates to the accounting for the variable conversion feature on the Company's 10% Convertible Debentures and its Series A Convertible Preferred Stock. The conversion feature on the 10% Convertible Debentures and the Series A Convertible Preferred Stock has been determined to be an embedded derivative under SFAS 133, which is required to be reflected as a liability at fair value. The 10% Convertible Debentures were previously reflected as containing a beneficial conversion feature under EITF 98-5. The increase (decrease) in net loss to common shareholders as a result of the net effect of the restatements for each of the quarters was \$(902,000), \$(1,181,000) and \$935,000, respectively for the quarters ended March 31, 2004, June 30, 2004 and September 30, 2004.

The restatement of these financial statements may lead to litigation claims and/or regulatory proceedings against us. The defense of any such claims or proceedings may cause the diversion of management's attention and resources, and we may be required to pay damages if any such claims or proceedings are not resolved in our favor. Any litigation or regulatory proceeding, even if resolved in our favor, could cause us to incur significant legal and other expenses. We also may have difficulty raising equity capital or obtaining other financing. We may not be able to effectuate our current business strategy. Moreover, we may be the subject of negative publicity focusing on the financial statement inaccuracies and resulting restatement and negative reactions from our stockholders, creditors or others with which we do business. The occurrence of any of the foregoing could harm our business and reputation and cause the price of our securities to decline.

**IF WE FAIL TO MAINTAIN AN EFFECTIVE SYSTEM OF INTERNAL AND DISCLOSURE CONTROLS, WE MAY NOT BE ABLE TO ACCURATELY REPORT OUR FINANCIAL RESULTS OR PREVENT FRAUD. AS A RESULT, CURRENT AND POTENTIAL STOCKHOLDERS COULD LOSE CONFIDENCE IN OUR FINANCIAL REPORTING WHICH WOULD HARM OUR BUSINESS AND THE TRADING PRICE OF OUR SECURITIES.** Effective internal and disclosure controls are necessary for us to provide reliable financial reports and effectively prevent fraud and to operate successfully as a public company. If we cannot provide reliable financial reports or prevent fraud, our reputation and operating results would be harmed. We have in the past discovered, and may in the future discover, areas of our disclosure and internal controls that need improvement. As a result after a review of our December 31, 2004 operating results, we identified certain deficiencies in some of our disclosure controls and procedures which we believe require remediation.

BDO Seidman, LLP advised our management that, in BDO Seidman, LLP's opinion, there were reportable conditions during 2004 which constituted material weaknesses in internal controls. The weakness concerned the interpretation and implementation of various complex accounting principles in the area of our financing transactions, and resulted from the fact that we needed additional personnel and outside consulting expertise with respect to the application of some of these more complex accounting principles to our financial statements.

We have remediated the material weakness in internal control over financial reporting and the ineffectiveness of our disclosure controls and procedure by conducting a review of our accounting treatment of our financing transactions and correcting our method of accounting for such transactions. Additionally, we are considering engaging outside expertise to enable us to properly apply complex accounting principles to our financial statements, when necessary. We cannot be certain that our efforts to improve our internal and disclosure controls will be successful or

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that we will be able to maintain adequate controls over our financial processes and reporting in the future. Any failure to develop or maintain effective controls or difficulties encountered in their implementation or other effective improvement of our internal and disclosure controls could harm our operating results or cause us to fail to meet our reporting obligations. If we are unable to adequately establish or improve our internal controls over financial reporting, our external auditors may not be able to issue



an unqualified opinion on the effectiveness of our internal controls. Ineffective internal and disclosure controls could also cause investors to lose confidence in our reported financial information, which would likely have a negative effect on the trading price of our securities.

### **RISKS ASSOCIATED WITH OUR COMMON STOCK, PREFERRED STOCK, NOTES AND DEBENTURES**

**WE DO NOT INTEND TO PAY DIVIDENDS ON OUR COMMON STOCK SO STOCKHOLDERS MUST SELL THEIR SHARES AT A PROFIT TO RECOVER THEIR INVESTMENT.**

We have never declared or paid any cash dividends on our common stock. We intend to retain future earnings, if any, for use in our business and do not anticipate paying cash dividends on our common stock in the foreseeable future. Because we may not pay dividends, our stockholders return on investment in our common stock will depend on their ability to sell our shares at a profit.

**THE MARKET PRICE OF OUR COMMON STOCK MAY BE VOLATILE, WHICH COULD CAUSE THE VALUE OF AN INVESTMENT IN OUR STOCK TO DECLINE.**

The market price of shares of our common stock has been and is likely to continue to be highly volatile. Factors that may have a significant effect on the market price of our common stock include the following:

sales of large numbers of shares of our common stocks in the open market, including shares issuable at a fluctuating conversion price at a discount to the market price of our common stock;

our operating results;

our need for additional financing;

announcements of technological innovations or new commercial products by us or our competitors;

developments in our patent or other proprietary rights or our competitors' developments;

our relationships with current or future collaborative partners;

governmental regulation; and

other factors and events beyond our control.

In addition, our common stock has been relatively thinly traded. Thinly traded common stock can be more volatile than common stock trading in an active public market. We cannot predict the extent to which an active public market for the common stock will develop.

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In addition, the stock market in general has experienced extreme volatility that often has been unrelated to the operating performance of particular companies. These broad market and industry fluctuations may adversely affect the trading price of our common stock, regardless of our actual operating performance.

As a result of potential stock price volatility, investors may be unable to resell their shares of our common stock at or above the cost of their purchase prices. In addition, companies that have experienced volatility in the market price of their stock have been the subject of securities class action litigation. If we were to become the subject of securities class action litigation, this could result in substantial costs, a diversion of our management's attention and resources and harm to our business and financial condition.

### ARCH HILL CAPITAL IS A CONTROLLING STOCKHOLDER OF LTC AND IS THEREFORE ABLE TO CONTROL THE MANAGEMENT AND POLICIES OF LTC.

Arch Hill Capital beneficially owns 232,229,000 shares of our common stock as of May 24, 2005. The 232,229,000 shares of our common stock beneficially owned by Arch Hill Capital constitute approximately 78% of our common stock on an as-converted basis, including shares beneficially owned by Arch Hill Capital and shares issuable upon conversion of convertible securities held by Arch Hill Capital but not including any shares issuable upon conversion of outstanding convertible securities held by any other person. Accordingly, Arch Hill Capital is a controlling stockholder and is able to control the outcome of all matters submitted to our stockholders for approval, including the election of our directors, amendments to our Certificate of Incorporation or a merger, sale of assets or other significant transactions, without the approval of our other stockholders. In addition, Arch Hill Capital controls a majority of the voting power of GAIA Holding and GAIA by virtue of its ownership of a controlling interest in us. As a result, Arch Hill Capital has an effective veto power over the management and operations of, and corporate transactions by, us, GAIA Holding or GAIA which management or non-control stockholders of such entities might desire.

The calculation of percentage of our common stock beneficially owned by Arch Hill Capital is based on the number of shares of our common stock outstanding as of May 24, 2005 (101,978,364) plus the number of shares of our common stock issuable to Arch Hill Capital upon conversion of convertible securities held by such entity.

**FUTURE SALES OF SHARES OF OUR COMMON STOCK COULD ADVERSELY AFFECT OUR STOCK PRICE.**

As of May 24, 2005, we had 101,978,364 shares of common stock outstanding, without taking into account shares issuable upon exercise of the outstanding 10% debentures, A Units, B Units, convertible notes, warrants or options or issuable under the standby equity distribution agreement. Of these shares, as of May 24, 2005, approximately 17 million shares of our common stock are subject to restrictions on resale pursuant to Rule 144 and approximately 85 million of the outstanding shares of our common stock are eligible for sale in the public market without restriction or are registered in the registration statement described below. The shares issuable upon exercise or conversion of our Preferred/Notes, convertible notes, and warrants are restricted securities, however, the holders of certain of these securities have registration rights with respect to the common stock issuable upon exercise or conversion of these securities.

We have filed a registration statement, which was declared effective on July 9, 2004, on April 29, 2004 to register the shares issuable upon conversion of \$5,000,000 in principal amount of our 10% debentures, shares issuable upon exercise of 10,900,000 warrants and 35,809,282 shares of common stock. The foregoing securities included in the registration statement include all of the January 10% debentures, the warrants held by the 10% debenture holders, the warrants held by the finder and all of the common shares, 10% debentures and warrants held by Arch Hill Capital and Arch Hill Ventures other than shares issuable upon exercise of 5,000,000 warrants held by Arch Hill Capital. However, pursuant to an agreement entered into with the holders of the January 2004 debentures, any Arch Hill Capital and Arch Hill Ventures securities included in the registration statement may not be sold prior to July 9, 2005, unless the January 2004 debentures have been repaid or converted prior to that time. During such time as the registration statement is effective these shares will be available for sale in the open market, other than the shares held by Arch Hill Capital or Arch Hill Ventures which may not be sold prior to July 9, 2005, unless the January 2004 debentures have been repaid or converted prior to that time.

We expect to file a registration statement under the Securities Act of 1933 during the latter part of the second quarter of 2005 to register all of the common stock held by or issuable to the A Unitholders and B Unitholders and the finder, shares issued or issuable to Cornell Capital under the standby equity distribution agreement and shares issuable to the holders of the 2005 Units. The future sale of a substantial number of shares of common stock by existing debentureholders, unitholders, stockholders, warrant holders and option holders and under the standby equity distribution agreement could have an adverse impact on the market price of our common stock. In addition, the market price of our common stock could drop in response to the perception that these sales could occur.

**OUR 10% DEBENTURES HAVE A FLUCTUATING CONVERSION RATE WHICH COULD CAUSE SUBSTANTIAL DILUTION TO STOCKHOLDERS AND ADVERSELY AFFECT OUR STOCK PRICE.**

Conversion of a material amount of our 10% debentures could materially affect a stockholder's investment in us. As of May 24, 2005, \$24,880 in principal amount of 10% debentures were issued and outstanding. The 10% debentures are convertible into a number of shares of common stock determined by dividing the principal amount converted by the conversion price in effect. If converted on May 24, 2005, the conversion price in effect would have been \$0.023 and the 10% debentures would have converted into 1,081,740 shares of our common stock, not including any shares that may be issued in respect of accrued interest at the option of the 10% debenture holders. This number of shares, however, could be significantly greater in the event of a decrease in the trading price of our common stock. The shares issuable upon conversion of the 10% debentures and attached warrants are registered under the Securities Act as described above.

Our 10% debentures are convertible by the debenture holders into shares of our common stock at any time at a conversion price equal to 50% of the average of the lowest three trading prices of our common stock for the twenty trading days ending one day prior to the date we receive a conversion notice from a 10% debenture holder. Conversion of a material amount of our 10% debentures could significantly dilute the value of a stockholder's investment in us.

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Attached warrants to purchase 2,500,000 shares of common stock issued to the purchasers of the 10% debentures are outstanding. The warrants are exercisable until January 20, 2009 at a price of \$2.00 per share. In addition, warrants to purchase 10,500,000 shares of our common stock at a price of \$2.40 per share are also held by the April 2004 debenture holders exercisable until April 13, 2009. The exercise price of the warrants may be adjusted from time to time under certain antidilution provisions in the event we issue securities at less than fair market value.

Also, in the absence of a proportionate increase in our earnings and book value, an increase in the aggregate number of our outstanding shares of common stock caused by a conversion of the 10% debentures or exercise of the warrants would dilute the earnings per share and book value of all of our outstanding shares of common stock. If these factors were reflected in the trading price of our common stock, the potential realizable value of a stockholder's investment in us could also be adversely affected.

**A DEFAULT BY US UNDER OUR JANUARY 2004 DEBENTURES WOULD ENABLE THE JANUARY 2004 DEBENTURE HOLDERS TO TAKE CONTROL OF SUBSTANTIALLY ALL OF OUR U.S. ASSETS.**

Our January 2004 debentures are secured by a security agreement under which we pledged substantially all of our U.S. assets, including our goods, fixtures, equipment, inventory, contract rights and receivables. A default by us under the January 2004 debentures would enable the January 2004 debenture holders to take control of substantially all of our U.S. assets. The January 2004 debenture holders have no operating experience in the industry which could force us to substantially curtail or cease our operations.

**THE SERIES A AND SERIES B PREFERRED STOCK/NOTES HAVE A FLUCTUATING CONVERSION RATE WHICH COULD CAUSE SUBSTANTIAL DILUTION TO STOCKHOLDERS AND ADVERSELY AFFECT OUR STOCK PRICE.**

Conversion of a material amount of our Series A Preferred Stock or Notes issued in lieu of Series A Preferred/Notes (the Series A Preferred/Notes) and our Series B Preferred Stock or Notes issued in lieu of Series B Preferred/Notes (the Series B Preferred/Notes) could materially affect a stockholder's investment in us. As of May 24, 2005, \$3,705,000 Series A Preferred/Notes were issued and outstanding and \$1,840,000 Series B Preferred/Notes were issued and outstanding. The Series A and B Units are convertible into a number of shares of common stock determined by dividing the principal amount of the Series A and Series B Preferred/Notes (\$5,545,000) converted by the conversion price in effect. Assuming a conversion price of \$0.05, the Series A and B Units would convert into 110,900,000 shares of our common stock. This number of shares, however, could be significantly greater in the event of a decrease in the trading price of our common stock. The shares issuable upon conversion of the Series A and Series B Preferred/Notes are expected to be registered under the Securities Act as described above.

The Series A and Series B Preferred/Notes are convertible by the holders into shares of our common stock at any time at a conversion price equal to 80% of the average of the trading prices of our common stock for the twenty trading days ending one day prior to the date we receive a conversion notice from a Series A and Series B Preferred/Notes holder. Conversion of a material amount of our Series A Preferred/Notes could significantly dilute the value of a stockholder's investment in us.

In addition, warrants to purchase shares of common stock have been issued to the purchasers of the Series A Preferred/Notes who have converted such Series A Preferred/Notes. The warrants are exercisable over the next five years at a fluctuating price.

Also, in the absence of a proportionate increase in our earnings and book value, an increase in the aggregate number of our outstanding shares of common stock caused by a conversion of the Series A and Series B Preferred/Notes or exercise of the warrants would dilute the earnings per share and book value of all of our outstanding shares of common stock. If these factors were reflected in the trading price of our common stock, the potential realizable value of a stockholder's investment in us could also be adversely affected.

**THE NOTES INCLUDED IN THE 2005 UNITS HAVE A FLUCTUATING CONVERSION RATE WHICH COULD CAUSE SUBSTANTIAL DILUTION TO STOCKHOLDERS AND ADVERSELY AFFECT OUR STOCK PRICE.**

Conversion of a material amount of the Notes included in the 2005 Units (the 8% Notes) could materially affect a stockholder's investment in us. As of May 24, 2005, \$163,000 8% Notes were issued and outstanding and we may issue and sell additional 2005 Units. The 8% Notes are

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convertible into a number of shares of common stock determined by dividing the principal amount of the 8% Notes converted by the conversion price in effect. Assuming a conversion price of \$0.05, the 8% Notes outstanding on May 24, 2005 would convert into 3,260,000 shares of our common stock. This number of shares, however, could be significantly greater in the event of a decrease in the trading price of our common stock. The shares issuable upon conversion of the 8% Notes are expected to be registered under the Securities Act as described above.

The 8% Notes are convertible by the holders into shares of our common stock at any time at a conversion price equal to 85% of the average of the trading prices of our common stock for the twenty trading days ending one day prior to the date we receive a conversion notice from a 8% Noteholder. Conversion of a material amount of our 8% Notes could significantly dilute the value of a stockholder's investment in us.

In addition, warrants to purchase shares of common stock have been issued to the purchasers of the Series A Preferred/Notes who have converted such 8% Notes. The warrants are exercisable for 1/2 of a share for each share acquired upon conversion of the 8% Notes and are exercisable over the next five years at a fluctuating price equal to 135% of the conversion price of the 8% Notes.

Also, in the absence of a proportionate increase in our earnings and book value, an increase in the aggregate number of our outstanding shares of common stock caused by a conversion of the 8% Notes or exercise of the warrants would dilute the earnings per share and book value of all of our outstanding shares of common stock. If these factors were reflected in the trading price of our common stock, the potential realizable value of a stockholder's investment in us could also be adversely affected.

### EXISTING SHAREHOLDERS MAY EXPERIENCE SIGNIFICANT DILUTION FROM OUR SALE OF SHARES UNDER THE STANDBY EQUITY DISTRIBUTION AGREEMENT.

The sale of shares pursuant to the standby equity distribution agreement may have a dilutive impact on our stockholders. As a result, our net income per share could decrease in future periods, and the market price of our common stock could decline. In addition, the lower our stock price is, the more shares of common stock we will have to issue under the standby equity distribution agreement to draw down the full amount. If our stock price is lower, then our existing stockholders would experience greater dilution.

### WE MAY NOT BE ABLE TO ACCESS SUFFICIENT FUNDS UNDER THE STANDBY EQUITY DISTRIBUTION AGREEMENT WHEN NEEDED.

We are dependent on external financing to fund our operations. Our financing needs are expected to be provided from the standby equity distribution agreement, in large part. No assurances can be given that such financing will be available in

sufficient amounts or at all when needed, in part, because the amount of financing available will fluctuate with the price and volume of our common stock. As the price and volume decline, then the amount of financing available under the standby equity distribution agreement will decline.

There are additional restrictions on our ability to request advances under the standby equity distribution agreement. For example, our ability to request an advance is conditioned upon us registering the shares of common stock with the Securities and Exchange Commission. Further, we may not request advances if the shares to be issued in connection with such advances would result in Cornell Capital Partners, L.P., owning more than 9.9% of our outstanding common stock. Even if we request advances the amount of each advance is limited to a maximum draw down of \$200,000 every five trading days and \$800,000 every thirty days. As of May 24, 2005 we have not filed a registration statement registering the shares issuable under the standby equity distribution agreement and no assurance can be made as to when such registration statement will be filed or will be effective.

### **ITEM 3. CONTROLS AND PROCEDURES**

As of March 31, 2005, an evaluation was carried out under the supervision and with the participation of management, including its Chief Executive Officer and Chief Financial Officer, of the effectiveness of disclosure controls and procedures. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in reports that the Company file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms. No changes in the Company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, its internal control over financial reporting, including any corrective actions with regard to significant deficiencies and material weaknesses, occurred during the first quarter of fiscal 2005 or subsequent to the date of the evaluation by its management thereof.

## **PART II.**

### **OTHER INFORMATION**

#### **ITEM 1. LEGAL PROCEEDINGS**

None.

#### **ITEM 2. UNREGISTERED SALES OF SECURITIES AND USE OF PROCEEDS**

All unregistered equity securities sold during the quarter ended March 31, 2005 have previously been reported in a Current Report on Form 8-K.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

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

None.

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K**

(a) The following Exhibits are filed as part of this Report or incorporated herein by reference:

- 4.5 Form of Unsecured 12% Debentures. <sup>(1)</sup>
- 10.70 Standby Equity Distribution Agreement dated as of March 11, 2005 between Lithium Technology Corporation and Cornell Capital Partners, L.P. [Schedules omitted]. <sup>(1)</sup>
- 10.71 Registration Rights Agreement dated March 11, 2005 by and between Lithium Technology Corporation and Cornell Capital Partners, LP in connection with the Standby Equity Distribution Agreement. <sup>(1)</sup>
- 10.72 Placement Agent Agreement dated as of March 11, 2005 by and among Lithium Technology Corporation, Cornell Capital Partners, LP and Newbridge Securities Corporation in connection with the Standby Equity Distribution Agreement. <sup>(1)</sup>
- 10.73 Escrow Agreement dated as of March 11, 2005 by and between Lithium Technology Corporation and Cornell Capital Partners, LP in connection with the Standby Equity Distribution Agreement. <sup>(1)</sup>
- 10.74 Form of Debenture Purchase Agreement dated as of March 11, 2005 [Schedules and Exhibits omitted]. <sup>(1)</sup>
- 10.75 Form of Escrow Agreement dated as of March 11, 2005 entered in connection with the Debenture Purchase Agreement. <sup>(1)</sup>
- 10.76 Fourth Amendment to Lease, dated March 31, 2005, between PMP Whitemarsh Associates and LTC. <sup>(1)</sup>
- 10.77 Series B Amendment Agreement, dated as of May 11, 2005. <sup>(1)</sup>
- 10.78 Form of Warrant dated May 6, 2005 issued to Bridgehead Partners, LLC. +
- 10.79 Form of 8% Convertible Notes +
- 10.80 Form of 135% Warrants +
- 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes Oxley Act of 2002 +



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- 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 +
- 32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 +

32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 +

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(1) Incorporated by reference to LTC's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2004.  
+ Exhibit filed herewith in this Report.

(b) Reports on Form 8K. During the quarter ended March 31, 2005, the Company filed the following Reports on Form 8-K.

On January 7, 2005, the Company filed a Report on Form 8-K reporting on the sale of securities in a private placement.

On February 1, 2005, the Company filed a Report on Form 8-K reporting on the sale of securities in a private placement.

On March 4, 2005, the Company filed a Report on Form 8-K reporting that it entered into the Standby Equity Distribution Agreement with Cornell Capital and reporting on a \$2.5 million debenture financing.

**SIGNATURES**

In accordance with Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: May 27, 2005

LITHIUM TECHNOLOGY CORPORATION

BY: /s/ Franz J. Kruger

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Franz J. Kruger, Chief Executive Officer  
(Principal Executive Officer)

BY: /s/ John J. McGovern

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John J. McGovern, Chief Financial Officer  
(Principal Financial and Accounting Officer)