CALMARE THERAPEUTICS Inc
Form 10-Q
May 19, 2016

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2016

or

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

For the transition period from __________________ to __________________

Commission file number 001-08696

**CALMARE THERAPEUTICS INCORPORATED**

(Exact name of registrant as specified in its charter)

*www.calmaretherapeutics.com*

| | |
|---|---|
| Delaware | 36-2664428 |
| (State or other jurisdiction of incorporation or organization) | (I. R. S. Employer Identification No.) |
| 1375 Kings Highway East, Suite 400 Fairfield, Connecticut | 06824 |
| (Address of principal executive offices) | (Zip Code) |

(203) 368-6044
(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months.

Yes x No ¨

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

| | |
|---|---|
| Large accelerated filer ¨ | Accelerated filer ¨ |
| Non-accelerated filer ¨ (Do not check if a smaller reporting company) | Smaller reporting company x |

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

Yes ¨ No x

The number of shares of the registrant’s common stock outstanding as of March 31, 2016 was 28,525,888 shares.

**CALMARE THERAPEUTICS INCORPORATED**

**INDEX TO QUARTERLY REPORT ON FORM 10-Q**

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**PART I. FINANCIAL INFORMATION**

**Item 1. Condensed Consolidated Interim Financial Statements**

**CALMARE THERAPEUTICS INCORPORATED AND SUBSIDIARY**

Condensed Consolidated Balance Sheets

| | March 31, 2016 (Unaudited) | December 31, 2015 |
|---|---|---|
| Assets | | |
| Current Assets: | | |
| Cash | $125,931 | $49,801 |
| Receivables, net of allowance of $317,659 at March 31, 2016 and December 31, 2015 | 74,327 | 33,081 |
| Inventory | 4,018,220 | 4,028,220 |
| Prepaid expenses and other current assets | 39,537 | 58,034 |
| Total current assets | 4,258,015 | 4,169,136 |
| | | |
| Property and equipment, net | 19,594 | 23,726 |
| Security deposits | 15,000 | 15,000 |
| TOTAL ASSETS | $4,292,609 | $4,207,862 |
| | | |
| Liabilities and Shareholders' Deficit | | |
| Current Liabilities: | | |
| Accounts payable | $1,929,063 | $1,895,382 |
| Liabilities under claims purchase agreement | 1,995,320 | 1,995,320 |
| Accounts payable, GEOMC | 4,182,380 | 4,182,380 |
| Accrued expenses and other liabilities | 2,423,262 | 2,248,024 |
| Notes payable | 4,381,458 | 3,785,063 |
| Deferred revenue | 6,400 | 6,400 |
| Series C convertible preferred stock derivative liability | 66,177 | 66,177 |
| Series C convertible preferred stock liability | 375,000 | 375,000 |
| Total current liabilities | 15,359,060 | 14,553,746 |
| | | |
| Note payable – long-term | 70,734 | 67,919 |
| | | |
| Commitments and Contingencies | | |
| Shareholders' deficit: | | |

| | | |
|---|---|---|
| 5% preferred stock, $25 par value, 35,920 shares authorized, 2,427 shares issued and outstanding | 60,675 | 60,675 |
| Series B preferred stock, $0.001 par value, 20,000 shares authorized, no shares issued and outstanding | - | - |
| Series C convertible preferred stock, $1,000 par value, 750 shares authorized, 375 shares issued and outstanding | - | - |
| Common stock, $.01 par value, 100,000,000 shares authorized, 28,525,888 shares issued and outstanding at March 31, 2016 and 28,515,888 shares issued and outstanding at December 31, 2015 | 285,258 | 285,158 |
| Capital in excess of par value | 48,765,848 | 48,611,413 |
| Accumulated deficit | (60,248,966) | (59,371,049 ) |
| Total shareholders’ deficit | (11,137,185) | (10,413,803 ) |
| | | |
| TOTAL LIABILITIES AND SHAREHOLDERS' DEFICIT | $4,292,609 | $4,207,862 |

*See accompanying notes*

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**PART I. FINANCIAL INFORMATION (Continued)**

**CALMARE THERAPEUTICS INCORPORATED AND SUBSIDIARY**

Condensed Consolidated Statements of Operations

(Unaudited)

| | Three months ended March 31, 2016 | | Three months ended March 31, 2015 | |
|---|---|---|---|---|
| Revenue | | | | |
| Product sales | $ 56,250 | | $ 7,950 | |
| Cost of product sales | 24,446 | | 2,297 | |
| Gross profit from product sales | 31,804 | | 5,653 | |
| | | | | |
| Other Revenue | | | | |
| Retained royalties | 69 | | 2,392 | |
| Other income | 13,287 | | 8,507 | |
| Total other revenue | 13,356 | | 10,899 | |
| | | | | |
| Operating expenses | | | | |
| Selling expenses | 6,557 | | 1,236 | |
| Personnel and consulting expenses | 449,056 | | 507,478 | |
| General and administrative expenses | 174,898 | | 323,639 | |
| Total operating expenses | 630,511 | | 832,353 | |
| | | | | |
| Operating loss | (585,351 | ) | (815,801 | ) |
| | | | | |
| Other expense | | | | |
| Interest expense | 292,566 | | 185,862 | |
| Loss on conversion of notes | - | | 2,588 | |
| Total other expense | 292,566 | | 188,450 | |
| | | | | |
| Loss before income taxes | (877,917 | ) | (1,004,251 | ) |

| | | | | | | |
|---|---|---|---|---|---|---|
| Provision (benefit) for income taxes | | - | | | - | |
| Net loss | $ | (877,917 | ) | $ | (1,004,251 | ) |
| Basic and diluted loss per share | $ | (0.03 | ) | $ | (0.04 | ) |
| Basic and diluted weighted average number of common shares outstanding: | | 28,525,558 | | | 26,767,978 | |

*See accompanying notes*

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**PART I. FINANCIAL INFORMATION (Continued)**

**CALMARE THERAPEUTICS INCORPORATED AND SUBSIDIARY**

Condensed Consolidated Statement of Changes in Shareholders' Deficit

For the Three Months Ended March 31, 2016

(Unaudited)

| | Preferred Stock | | Common Stock | | Capital | | Total |
|---|---|---|---|---|---|---|---|
| | Shares outstanding | Amount | Shares outstanding | Amount | In excess of par value | Accumulated deficit | shareholders' deficit |
| Balance January 1, 2016 | 2,427 | $60,675 | 28,515,888 | $285,158 | $48,611,413 | $(59,371,049) | $(10,413,803) |
| Net loss | - | - | - | - | - | (877,917) | (877,917) |
| Common stock issued to directors | - | - | 10,000 | 100 | 1,800 | - | 1,900 |
| Stock option compensation expense | - | - | - | - | 7,180 | - | 7,180 |
| Warrant and beneficial conversion feature on notes payable | - | - | - | - | 145,455 | - | 145,455 |
| Balance March 31, 2016 | 2,427 | $60,675 | 28,525,888 | $285,258 | $48,765,848 | $(60,248,966) | $(11,137,185) |

*See accompanying notes*

**PART I. FINANCIAL INFORMATION (Continued)**

**CALMARE THERAPEUTICS INCORPORATED AND SUBSIDIARY**

Condensed Consolidated Statements of Cash Flows

(Unaudited)

| | Three months ended March 31, 2016 | Three months ended March 31, 2015 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net loss | $ (877,917) | $ (1,004,251) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation and amortization | 4,132 | 4,459 |
| Stock option compensation expense | 7,180 | 16,069 |
| Share-based compensation – common stock | 1,900 | 2,125 |
| Common stock and warrants issued to consultants | - | 182,600 |
| Debt discount amortization | 144,665 | 49,720 |
| Loss on conversion of notes | - | 2,588 |
| Changes in assets and liabilities: | | |
| Receivables | (41,246) | (1,072) |
| Prepaid expenses and other current assets | 18,497 | 73,466 |
| Inventory | 10,000 | - |
| Accounts payable, accrued expenses and other liabilities | 208,919 | 385,457 |
| Deferred revenue | - | (5,905) |
| Net cash used in operating activities | (523,870) | (294,744) |
| Cash flows from financing activities: | | |
| Proceeds from notes payable | 600,000 | 257,000 |
| Repayment of note and warrant settlement | - | (42,500) |
| Proceeds from common stock and warrants | - | 75,000 |
| Net cash provided by financing activities | 600,000 | 289,500 |
| Net increase (decrease) in cash | 76,130 | (5,244) |
| Cash at beginning of period | 49,801 | 5,742 |
| Cash at end of period | $ 125,931 | $ 501 |

**Supplemental disclosure of non-cash transactions:**

During the quarter ended March 31, 2015, the Company issued 500,000 shares with a fair value of $80,000 to an advisory firm for consulting services. The Company is amortizing the $80,000 over the service period and recorded $20,000 of expense in the quarter ended March 31, 2015.

During the quarter ended March 31, 2015, the Company issued 120,000 shares to an advisory firm for consulting services. The shares vested in two tranches, with 60,000 shares vesting in the quarter ended December 31, 2014 and remaining 60,000 shares vesting in the quarter ended March 31, 2015. The Company recorded consulting expenses of $10,800 in the quarter ended December 31, 2014 and $27,600 of consulting expenses in the quarter ended March 31, 2015. In each instance, the expense was based on the fair value on the vesting date.

During the quarter ended March 31, 2015, the Company issued 333,333 stock warrants for consulting services performed and recorded consulting expense of $75,000 for the fair value of the warrants.

During the quarter ended March 31, 2015, the Company allocated $59,480 of convertible note proceeds for the fair value of warrants and beneficial conversion feature to additional paid-in capital.

During the quarter ended March 31, 2016, the Company allocated $145,455 of convertible note proceeds for the fair value of warrants and beneficial conversion feature to additional paid-in capital.

*See accompanying notes*

**PART I. FINANCIAL INFORMATION (Continued)**

**CALMARE THERAPEUTICS INCORPORATED AND SUBSIDIARY**

Notes to Condensed Consolidated Interim Financial Statements

(Unaudited)

## 1. BASIS OF PRESENTATION

The interim condensed consolidated financial information presented in the accompanying condensed consolidated financial statements and notes hereto is unaudited.

Calmare Therapeutics Incorporated and its majority-owned (56.1%) subsidiary, Vector Vision, Inc., (collectively, the “Company,” "we,” “our,” or “us”), is a medical device company developing and commercializing innovative products and technologies for chronic neuropathic pain and wound care affliction patients. The Company’s flagship medical device, the Calmare® Pain Therapy Device (the “Calmare Device”), is the world’s only non-invasive and non-addictive modality that can successfully treat chronic, neuropathic pain.

The consolidated financial statements include the accounts of the Company and its majority-owned subsidiary, Vector Vision, Inc. Inter-company accounts and transactions have been eliminated in consolidation.

We believe we have made all adjustments necessary, consisting only of normal recurring adjustments, to present the unaudited condensed consolidated financial statements in conformity with accounting principles generally accepted in the U.S. The results for the three ended March 31, 2016 are not necessarily indicative of the results that can be expected for the full year ending December 31, 2016.

The interim unaudited condensed consolidated financial statements and notes thereto, should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2015 filed with the Securities and Exchange Commission (“SEC”) on April 14, 2016.

During the three months ended March 31, 2016, we had a significant concentration of revenues from the Calmare® Device. The percentages of gross revenue attributed to sales and rentals of Calmare Devices, in the three months ended March 31, 2016 and March 31, 2015, were 89% and 74%, respectively. Additionally, the percentage of gross revenue attributed to other Calmare Device related sales of equipment and training, in the three months ended March 31, 2016 and March 31, 2015, were 10 % and 16%, respectively. We continue to attempt to expand our sales activities for the Calmare Device and expect the majority of our revenues to come from this technology.

The Company has incurred operating losses since fiscal 2006 and has a working capital deficiency and shareholders' deficiency at March 31, 2016. The Company has taken steps to reduce its operating expenses as well as increase revenue from sales of Calmare Devices and related sales. However, even at the reduced spending levels, should the anticipated increase in revenue from sales of Calmare Devices and related sales not occur the Company may not have sufficient cash flow to fund operations through 2016 and into 2017. These conditions raise substantial doubt about the Company's ability to continue as a going concern. The financial statements do not include adjustments to reflect the possible future effect of the recoverability and classification of assets or amounts and classifications of liabilities that may result from the outcome of this uncertainty.

The Company's continuation as a going concern is dependent upon its developing recurring revenue streams sufficient to cover operating costs. The Company does not have any significant individual cash or capital requirements in the budget going forward. If necessary, the Company will attempt to meet anticipated operating cash requirements by further reducing costs, issuing debt and/or equity, and/or pursuing sales of certain assets and technologies while we pursue licensing and distribution opportunities for our remaining legacy portfolio of technologies. There can be no assurance that the Company will be successful in such efforts. Failure to develop a recurring revenue stream sufficient to cover operating expenses could negatively affect the Company's financial position.

Our liquidity requirements arise principally from our working capital needs, including funds needed to sell our current technologies and obtain new technologies or products, and protect and enforce our intellectual property rights, if necessary. We fund our liquidity requirements with a combination of cash on hand, debt and equity financing, sales of common stock and cash flows from operations, if any, including royalty legal awards. At March 31, 2016, the Company had outstanding debt in the form of promissory notes with a total principal amount of $5,353,000 and a carrying value of $4,938,000.

**2. NET LOSS PER COMMON SHARE**

The following sets forth the denominator used in the calculations of basic net loss per share and net loss per share assuming dilution:

| | Three months ended March 31, 2016 | Three months ended March 31, 2015 |
|---|---|---|
| Denominator for basic net loss per share, weighted average shares outstanding | 28,525,558 | 26,767,978 |
| Dilutive effect of common stock options | **N/A** | N/A |
| Dilutive effect of Series C convertible preferred stock, convertible debt and warrants | **N/A** | N/A |
| Denominator for diluted net loss per share, weighted average shares outstanding | 28,525,558 | 26,797,978 |

Due to the net loss incurred for the three months ended March 31, 2016, and March 31, 2015, the denominator used in the calculation of basic net loss per share was the same as that used for net loss per share, assuming dilution, since the effect of any options, convertible preferred shares, convertible debt or warrants would have been anti-dilutive.

Potentially dilutive securities outstanding are summarized as follows:

| | March 31,2016 | March 31, 2015 |
|---|---|---|
| Exercise of common stock options | 1,738,500 | 1,742,500 |
| Exercise of common stock warrants | 12,569,898 | 5,727,251 |
| Conversion of Series C convertible preferred stock | 1,918,159 | 1,470,588 |
| Conversion of convertible debt | 14,971,505 | 6,306,802 |
| Total | 31,198,062 | 15,247,141 |

**3. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS**

In May 2014, the FASB issued Accounting Standards Update ("ASU") No. 2014-09, *Revenue from Contracts with Customers*, as amended by ASU 2015-14, that outlines a single comprehensive model for entities to use in accounting for revenue recognition and supersedes most current revenue recognition guidance, including industry-specific guidance. The amendments in this accounting standard update are intended to provide a more robust framework for addressing revenue issues, improve comparability of revenue recognition practices, and improve disclosure requirements. The amendments in this accounting standard update are effective for interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted after December 31, 2016. The Company is currently assessing the impact that this standard will have on its consolidated financial statements.

In August 2014, the FASB issued ASU No. 2014-15, *Presentation of Financial Statements – Going Concern,* which provides guidance on management's responsibility in evaluating whether there is substantial doubt about a company's ability to continue as a going concern and the related footnote disclosure. For each reporting period, management will be required to evaluate whether there are conditions or events that raise substantial doubt about a company's ability to continue as a going concern within one year from the date the financials are issued. When management identifies conditions or events that raise substantial doubt about the entity's ability to continue as a going concern, the ASU also outlines disclosures that are required in the company's footnotes based on whether or not there are any plans intended to mitigate the relevant conditions or events to alleviate the substantial doubt. The ASU becomes effective for annual periods ending after December 15, 2016, and for any annual and interim periods thereafter. Early application is permitted. The Company is currently assessing the impact that this standard will have on its consolidated financial statements.

In July 2015, the FASB issued ASU No. 2015-11, *Inventory – Simplifying the Measurement of Inventory,* which requires that inventory be measured at the lower of cost and net realizable value. Prior to the issuance of the new guidance, inventory was measured at the lower of cost or market. Replacing the concept of market with the single measurement of net realizable value is intended to create efficiencies for preparers. Inventory measured using the last-in, first-out (LIFO) method and the retail inventory method are not impacted by the new guidance. The ASU becomes effective for fiscal years beginning after December 15, 2016, including interim periods with those fiscal years. Early application is permitted. We do not expect the adoption to have a material impact on our consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, *Leases*, to increase the transparency and comparability about leases among entities. The new guidance requires lessees to recognize a lease liability and a corresponding lease asset for virtually all lease contracts. It also requires additional disclosures about leasing arrangements. The ASU is effective for interim and annual periods beginning after December 15, 2018, and requires a modified retrospective approach to adoption. Early adoption is permitted. The Company is currently evaluating the impact of this new standard on its consolidated financial statements and related disclosures.

In March 2016, the FASB issued ASU No. 2016-09, *Compensation - Stock Compensation Improvements to Employee Share-Based Payment Accounting*, which is intended to simplify certain aspects of the accounting for share-based payments to employees. The guidance in this standard requires all income tax effects of awards to be recognized in the income statement when the awards vest or are settled rather than recording excess tax benefits or deficiencies in additional paid-in capital. The guidance in this standard also allows an employer to repurchase more of an employee's shares than it can today for tax withholding purposes without triggering liability accounting and to make a policy election to account for forfeitures as they occur. The standard becomes effective for interim and annual periods beginning after December 15, 2016, and requires a modified retrospective approach to adoption. Early adoption is permitted. The Company is currently evaluating the impact of this new standard on its consolidated financial statements and related disclosures.

**4. RECEIVABLES**

Receivables consist of the following:

| | March 31, 2016 | December 31, 2015 |
|---|---|---|
| Calmare device sales receivable, net of allowance of $210,284 at March 31, 2016 and December 31, 2015 | $ 71,200 | $ 31,827 |
| Royalties, net of allowance of $101,154 at March 31, 2016 and December 31, 2015 | - | - |
| Other, net of allowance of $6,221 at March 31, 2016 and December 31, 2015 | 3,127 | 1,254 |
| Total | $ 74,327 | $ 33,081 |

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**5. AVAILABLE-FOR-SALE AND EQUITY SECURITIES**

The fair value of the equity securities we held were categorized as available-for-sale securities, which were carried at a fair value of zero, consisted of shares in Security Innovation and Xion Pharmaceutical Corporation (“Xion”). The Company owns 223,317 shares of stock in the privately held Security Innovation, an independent provider of secure software located in Wilmington, MA.

In September 2009 we announced the formation of a joint venture with Xion for the commercialization of our patented melanocortin analogues for treating sexual dysfunction and obesity. The Company received 60 shares of privately held Xion Pharmaceutical Corporation common stock in June 2010. The Company currently owns 30% of the outstanding stock of Xion Pharmaceutical Corporation.

**6. FAIR VALUE MEASUREMEMENTS**

The Company measures fair value in accordance with Topic 820 of the FASB Accounting Standards Codification (“ASC”), Fair Value Measurement (“ASC 820”), which provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under ASC 820 are described as follows:

Level 1 - Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets that the Company has the ability to access.

Level 2 - Inputs to the valuation methodology include:

Quoted prices for similar assets or liabilities in active markets;
Quoted prices for identical or similar assets or liabilities in inactive markets;
Inputs other than quoted prices that are observable for the asset or liability;
Inputs that are derived principally from or corroborated by observable market data by correlation or other means.

If the asset or liability has a specified (contractual) term, the Level 2 input must be observable for substantially the full term of the asset or liability.

Level 3 - Inputs to the valuation methodology are unobservable and significant to the fair value measurement

The asset's or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques used need to maximize the use of observable inputs and minimize the use of unobservable inputs.

The Company values its derivative liability associated with the variable conversion feature on its Series C Convertible Preferred Stock (Note 12) based on the market price of its common stock. For each reporting period the Company calculates the amount of potential common stock that the Series C Preferred Stock could convert into based on the conversion formula (incorporating market value of our common stock) and multiplies those converted shares by the market price of its common stock on that reporting date. The total converted value is subtracted by the consideration paid to determine the fair value of the derivative liability. The Company classified the derivative liability of approximately $66,000 at both March 31, 2016 and December 31, 2015, in Level 2 of the fair value hierarchy.

The methods described above may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the Company believes its valuation method is appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value could result in a different fair value measurement at the reporting date.

The carrying amounts reported in our Condensed Consolidated Balance Sheet for cash, accounts receivable, liabilities under the claims purchase agreement, accounts payable, GEOMC, notes payable, deferred revenue, and preferred stock liability approximate fair value due to the short-term maturity of those financial instruments.

**7. PREPAID EXPENSES AND OTHER CURRENT ASSETS**

Prepaid expenses and other current assets consist of the following:

| | March 31, 2016 | December 31, 2015 |
|---|---|---|
| Prepaid insurance | $ 17,907 | $ 47,931 |
| Other | 21,630 | 10,103 |
| Prepaid expenses and other current assets | $ 39,537 | $ 58,034 |

**8. PROPERTY AND EQUIPMENT**

Property and equipment, net, consist of the following:

| | March 31, 2016 | December 31, 2015 |
|---|---|---|
| Property and equipment, gross | $ 220,051 | $ 220,051 |
| Accumulated depreciation and amortization | (200,457 ) | (196,325 ) |
| Property and equipment, net | $ 19,594 | $ 23,726 |

Depreciation and amortization expense was $4,132 during the three months ended March 31, 2016, and $4,459 for the three months ended March 31, 2015.

**9. ACCRUED EXPENSES AND OTHER LIABILITIES**

Accrued expenses and other liabilities consist of the following:

| | March 31, 2016 | December 31, 2015 |
|---|---|---|
| Royalties payable | $500,591 | $ 487,739 |
| Accrued compensation | 49,769 | 49,769 |
| Commissions payable | 22,369 | 15,900 |
| Accrued interest payable | 1,712,187 | 1,589,256 |
| Other | 138,346 | 105,360 |
| Accrued expenses and other liabilities, net | $2,423,262 | $ 2,248,024 |

Excluded above is approximately $217,000 of accrued expenses and other liabilities at March 31, 2016 and December 31, 2015, that fall under the Liability Purchase Agreement (“LPA”) with ASC Recap, LLC (“ASC Recap”), and are expected to be repaid using the process as described in Note 10. Because there can be no assurance that the Company will be successful in completing this process, the Company retains ultimate responsibility for these liabilities, until fully paid down.

**10. LIABILITIES ASSIGNED TO LIABILITY PURCHASE AGREEMENT**

During the third quarter of 2013, the Company negotiated a LPA with Southridge, Partners II, L.P. (“Southridge”). The LPA takes advantage of a provision in the Securities Act of 1933, Section 3(a)(10), that allows the exchange of claims, securities, or property for stock when the arrangement is approved for fairness by a court proceeding. The process, approved by the court in August 2013, has the potential to eliminate nearly $2.1 million of our financial obligations to existing creditors who agreed to participate and executed claims purchase agreements with Southridge’s affiliate ASC Recap accounting for $2,093,303 of existing payables, accrued expenses and other current liabilities, and notes payable. The process began with the issuance in September 2013 of 1,618,235 shares of the Company’s common stock to ASC Recap. During September and October 2013, ASC Recap sold the Company’s common stock and during the three months ended March 31, 2014 paid creditors approximately $80,000 from the proceeds and retained a service fee of approximately $27,000. During 2014, the Company also made cash payments of $18,000 for accrued expenses previously included in the LPA amount. As of May 16, 2016, no further shares of the Company’s common stock had been issued to ASC Recap to settle creditors’ balances.

There can be no assurance that the Company will be successful in completing this process with Southridge, and the Company retains ultimate responsibility for this debt, until fully paid.

**11. NOTES PAYABLE**

Notes payable consist of the following:

| **Short term** | March 31, 2016 | December 31, 2015 |
|---|---|---|
| 90 day Convertible Notes (Chairman of the Board) | $ 2,498,980 | $ 2,498,980 |
| 24 month Convertible Notes ($100,000 to Board member) | 225,000 | 225,000 |
| Series A-3 OID Convertible Notes and Warrants | 14,353 | 14,353 |
| Series B-2 OID Convertible Notes and Warrants | 2,129,105 | 1,532,710 |
| Short term notes payable, gross | 4,867,438 | 4,271,043 |
| Less LPA amount | (485,980) | (485,980) |
| Short term notes payable, net | $ 4,381,458 | $ 3,785,063 |

| **Long term** | March 31, 2016 | December 31, 2015 |
|---|---|---|
| Series B-1 OID Convertible Notes and Warrants | $ 70,734 | $ 67,919 |

Details of notes payable as of March 31, 2016 are as follows:

| Short term | Principal Amount | Carrying Value | Cash Interest Rate | Common Stock Conversion Price | Maturity Date |
|---|---|---|---|---|---|
| 90 day Convertible Notes (Chairman of the Board) | $2,498,980 | $2,498,980 | 6 % | $1.05 | Various 2014 |
| 24 month Convertible Notes ($100,000 to Board member) | 225,000 | 225,000 | 6 % | $1.05 | 3/2014 – 6/2014 |
| Series A-3 OID Convertible Notes and Warrants | 11,765 | 14,353 (1) | None | $0.25 | 1/2015 |
| Series B-2 OID Convertible Notes and Warrants | 2,537,647 | 2,129,105 | None | $0.20 – 0.25 | 11/2015 – 12/2016 |
| Short term notes payable, gross | $5,273,392 | 4,867,438 | | | |
| Less LPA amount | | (485,980 ) | | | |
| Short term notes payable, net | | $4,381,458 | | | |
| | | | | | |
| Long term | | | | | |
| Series B-1 OID Convertible Notes and Warrants | $80,000 | $70,734 | None | $0.23 | 3/2017 |

(1) Includes $2,588 of accrued loss on conversion of OID note.

**<u>90 day Convertible Notes</u>**

The Company has issued 90-day notes payable to borrow funds from a director, now the chairman of our Board, as follows:

| | |
|---|---|
| 2013 | $1,188,980 |
| 2012 | 1,210,000 |
| 2011 | 100,000 |
| Total | $2,498,980 |

These notes have been extended several times and all bear 6.00% simple interest. A conversion feature was added to the Notes when they were extended, which allows for conversion of the eligible principal amounts to common stock at any time after the six month anniversary of the effective date – the date the funds are received – at a rate of $1.05 per share. Additional terms have been added to all Notes to include additional interest of 1% simple interest per month on all amounts outstanding for all Notes if extended beyond their original maturity dates and to provide the lender with a security interest in unencumbered inventory and intangible assets of the Company other than proceeds relating to the

Calmare Device and accounts receivable.

Due to the Board's February 10, 2014 decision authorizing management to nullify certain actions taken by prior management, the additional terms noted above were not approved and therefore, the additional interest for the extension of the Notes was not recorded. During 2014, management has been in negotiations to modify the terms of the Notes. However, until those negotiations are resolved, the Company has agreed to honor the additional terms and as such, the Company recorded additional interest of approximately $102,000 and $92,000 during the three months ended March 31, 2016 and March 31, 2015, respectively, and has recorded additional interest in total of $1,109,000.

A total of $485,980 of the aforementioned notes issued between December 1, 2012 and March 31, 2013 fall under the LPA with ASC Recap, and are expected to be repaid using the process as described in Note 10. Because there can be no assurance that the Company will be successful in completing this process, the Company retains ultimate responsibility for this debt, until fully paid down. As a result, the Company continues to accrue interest on these notes and they remain convertible as described above.

**24 month Convertible Notes**

In March 2012, the Company issued a 24-month convertible promissory note to borrow $100,000. Additional 24-month convertible promissory notes were issued in April 2012 ($25,000) and in June 2012 ($100,000). All of the notes bear 6.00% simple interest. Conversion of the eligible principal amounts to common stock is allowed at any time at a rate of $1.05 per share.

As of March 31, 2016, the Company has not repaid the principal due on the March 2012 $100,000 note, the April 2012 $25,000 note or the June 2012 $100,000 note and is in default under the terms of the notes. As of March 31, 2016, there is also unpaid interest of $43,191 related to these notes.

**Series A-3 Original Issue Discount Convertible Notes and Warrants**

During the quarter ended March 31, 2014, the Company did a private offering of a third tranche of convertible notes and warrants, under which it issued $64,706 of convertible promissory notes for consideration of $55,000, the difference between the proceeds from the notes and principal amount consists of $9,706 of original issue discount. The notes are convertible at an initial conversion price of $0.25 per share any time after issuance thereby having an embedded beneficial conversion feature.

The note holders were also issued market-related warrants for 129,412 in shares of common stock. The warrants have an exercise price of $0.60 and a term of 2 years. The beneficial conversion feature, if any, and the warrants were recorded to additional paid-in-capital. The Company allocated the proceeds received to the notes, the beneficial conversion feature and the warrants on a relative fair value basis at the time of issuance. The total debt discount is amortized over the life of the notes to interest expense.

The beneficial conversion feature was valued at the intrinsic value on the issuance date. The intrinsic value represents the difference between the conversion price and the fair value of the common stock multiplied by the number of share into which the note is convertible. We estimated the fair value of the warrants on the issue date using a Black-Scholes pricing model with the following assumptions:

| | Warrants | |
|---|---|---|
| Expected term | 2 years | |
| Volatility | 184.88 | % |
| %%Risk Free Rate | 0.32 | % |

The proceeds of the Notes issued during the three months ended March 31, 2014 were allocated to the components as follows:

| | Proceeds allocated at issue date |
|---|---|
| Private Offering Notes | $ 32,390 |
| Private Offering Warrants | 14,845 |
| Beneficial Conversion feature | 7,765 |
| Total | $ 55,000 |

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During the quarter ended June 30, 2014, certain holders of Series A-3 OID convertible notes and warrants delivered to the Company a notice of conversion related to the Series A-3 OID convertible notes. Due to the timing of receipt of the notices by the Company, certain Note holders ("Noteholders") received their shares during the quarter ended June 30, 2014, while other Noteholders received or are due to receive their shares after June 30, 2014. Additionally, the Company offered certain Noteholders an inducement to convert their notes to shares. The inducement, when offered, provided Noteholders a conversion price of $0.20. All other original terms, including the warrant terms, remained the same. Upon notice of conversion and irrespective of whether the shares were delivered in the quarter ended June 30, 2014 or subsequent to June 30, 2014 to the Company: (i) accelerated and recognized as interest expense in the current period any remaining discount, and (ii) recognized a loss for the fair value of the additional shares offered as the conversion inducement.

Presented below is summary information related to the conversion:

| | |
|---|---|
| Statement of Operations | |
| Loss on conversion of notes | $43,288 |
| Accelerated interest expense | $35,109 |
| | |
| Balance Sheet | |
| Shares issued as of June 30, 2014 | 798,825 |
| Shares to be issued subsequent to June 30, 2014 | 529,415 |
| Principal amount of notes converted | $265,648 |

During the quarter ended March 31, 2015, a holder of Series A-3 OID convertible notes and warrants delivered to the Company a notice of conversion related to the Series A-3 OID convertible notes. Additionally, the Company offered the Noteholder an inducement to convert his/her notes to shares. The inducement provided the Noteholder a conversion price of $0.20. All other original terms, including the warrant terms, remained the same. Upon notice of conversion, the Company: (i) accelerated and recognized as interest expense in the current period any remaining discount, and (ii) recognized a loss for the fair value of the additional shares offered as the conversion inducement. As of March 31, 2016, the Company had not issued the shares due related to the conversion notice.

Presented below is summary information related to the conversion:

| | |
|---|---|
| Statement of Operations | |
| Loss on conversion of notes | $2,588 |
| Accelerated interest expense | $- |
| | |
| Balance Sheet | |
| Shares issued | - |

| | |
|---|---|
| Principal amount of notes converted | $11,765 |

**Series B-1 Original Issue Discount Convertible Notes and Warrants**

During the quarter ended March 31, 2014, the Company did a private offering of convertible notes and warrants, under which it issued $80,000 of convertible promissory notes for consideration of $65,000, the difference between the proceeds from the notes and principal amount consists of $15,000 of original issue discount. The notes are convertible at an initial conversion price of $0.35 per share any time after issuance thereby having an embedded beneficial conversion feature. The note holders were also issued market-related warrants for 185,714 in shares of common stock. The warrants have an exercise price of $0.45 and a 4-year term. The beneficial conversion feature and the warrants were recorded to additional paid-in-capital. The Company allocated the proceeds received to the notes, the beneficial conversion feature and the warrants on a relative fair value basis at the time of issuance. The total debt discount is amortized over the life of the notes to interest expense.

The beneficial conversion feature was valued at the intrinsic value on the issuance date. The intrinsic value represents the difference between the conversion price and the fair value of the common stock multiplied by the number of share into which the note is convertible. We estimated the fair value of the warrants on the issue date using a Black-Scholes pricing model with the following assumptions:

| | Warrants | |
|---|---|---|
| Expected term | 4 years | |
| Volatility | 151.52 | % |
| Risk Free Rate | 1.32 | % |

The proceeds of the Notes were allocated to the components as follows:

| | Proceeds allocated at issue date |
|---|---|
| Private Offering Notes | $ 34,272 |
| Private Offering Warrants | 26,811 |
| Beneficial Conversion feature | 3,917 |
| Total | $ 65,000 |

The Series B-1 OID notes include an anti-dilution provision that if the Company issues more than 20 million shares of its common stock, subject to certain exceptions, the conversion price of the notes and the conversion price of the warrants would be subject to an automatic pre-determined price adjustment. During the quarter ended December 31, 2014 the Series B-1 OID noteholder and the Company agreed that this anti-dilution provision had been triggered and the Series B-1 OID note share conversion price was adjusted down to $0.23 per share, which increased the number of shares available upon conversion to 347,826. The anti-dilution provision in the Warrant changed the share purchase price downward to $0.33 per share but did not change the number of shares available under the Warrant.

As a result of the triggering of the above noted one time anti-dilution provision, the Company reallocated the proceeds of the Notes during the quarter ended December 31, 2014 as follows:

| | Proceeds allocated at issue date |
|---|---|
| Private Offering Notes | $ 46,222 |
| Private Offering Warrants | 18,778 |
| Total | $ 65,000 |

**Series B-2 OID Convertible Notes and Warrants**

During the quarter ended December 31, 2014, the Company did private offerings of convertible notes and warrants, under which it issued $358,824 of convertible promissory notes for consideration of $305,000, the difference between the proceeds from the notes and principal amount consists of $53,824 of original issue discount. The notes are convertible at an initial conversion price of $0.20 per share any time after issuance thereby having an embedded beneficial conversion feature. The note holders were also issued market-related warrants for 897,060 in shares of common stock. The warrants have an exercise price of $0.60 and a 1-year term. The beneficial conversion feature and the warrants were recorded to additional paid-in-capital. The Company allocated the proceeds received to the notes, the beneficial conversion feature and the warrants on a relative fair value basis at the time of issuance. The total debt discount is amortized over the life of the notes to interest expense.

The beneficial conversion feature was valued at the intrinsic value on the issuance date. The intrinsic value represents the difference between the conversion price and the fair value of the common stock multiplied by the number of share into which the note is convertible. We estimated the fair value of the warrants on the issue date using a Black-Scholes pricing model with the following assumptions:

| | Warrants | |
|---|---|---|
| Expected term | 1 year | |
| Volatility | 188.31 | % |
| Risk Free Rate | 0.11 | % |

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The proceeds of the Notes were allocated to the components as follows:

| | Proceeds allocated at issue date |
|---|---|
| Private Offering Notes | $ 224,679 |
| Private Offering Warrants | 57,854 |
| Beneficial Conversion feature | 22,467 |
| Total | $ 305,000 |

During the quarter ended June 30, 2015, a holder of Series B-2 OID convertible notes and warrants delivered to the Company a notice of conversion related to the Series B-2 OID convertible notes, with a principal amount of $5,882. In the quarter ended September 30, 2015, the Company issued 29,410 shares due related to the conversion notice.

As of March 31, 2016, the remaining notes have passed their maturity date. The Company has not repaid the amounts due on these notes and is in default under the terms of the notes.

During the quarter ended March 31, 2015, the Company did an additional private offering of convertible notes and warrants, under which it issued $302,353 of convertible promissory notes for consideration of $257,000, the difference between the proceeds from the notes and principal amount consists of $45,353 of original issue discount. The notes are convertible at an initial conversion price of $0.20 per share any time after issuance thereby having an embedded beneficial conversion feature. The note holders were also issued market-related warrants for 755,882 in shares of common stock. The warrants have an exercise price of $0.60 and a 1-year term. The beneficial conversion feature and the warrants were recorded to additional paid-in-capital. The Company allocated the proceeds received to the notes, the beneficial conversion feature and the warrants on a relative fair value basis at the time of issuance. The total debt discount is amortized over the life of the notes to interest expense.

The beneficial conversion feature was valued at the intrinsic value on the issuance date. The intrinsic value represents the difference between the conversion price and the fair value of the common stock multiplied by the number of shares into which the note is convertible. We estimated the fair value of the warrants on the issue date using a Black-Scholes pricing model with the following assumptions:

| | **Warrants** | |
|---|---|---|
| Expected term | 1 year | |
| Volatility | 180.15-185.71 | % |
| Risk Free Rate | 0.18-0.22 | % |

The proceeds of the Notes were allocated to the components as follows:

| | Proceeds allocated at issue date |
|---|---|
| Private Offering Notes | $ 197,521 |
| Private Offering Warrants | 46,097 |
| Beneficial Conversion feature | 13,382 |
| Total | $ 257,000 |

As of March 31, 2016, the remaining notes have passed their maturity date. The Company has not repaid the amounts due on these notes and is in default under the terms of the notes.

During the quarter ended September 30, 2015, the Company did an additional private offering of convertible notes and warrants, under which it issued $705,882 of convertible promissory notes for consideration of $600,000, the difference between the proceeds from the notes and principal amount consists of $105,882 of original issue discount. The notes are convertible at an initial conversion price of $0.25 per share any time after issuance thereby having an embedded beneficial conversion feature. The note holders were also issued market-related warrants for 1,411,764 in shares of common stock. The warrants have an exercise price of $0.60 and a 1-year term. The beneficial conversion feature and the warrants were recorded to additional paid-in-capital. The Company allocated the proceeds received to the notes, the beneficial conversion feature and the warrants on a relative fair value basis at the time of issuance. The total debt discount is amortized over the life of the notes to interest expense.

The beneficial conversion feature was valued at the intrinsic value on the issuance date. The intrinsic value represents the difference between the conversion price and the fair value of the common stock multiplied by the number of shares into which the note is convertible. We estimated the fair value of the warrants on the issue date using a Black-Scholes pricing model with the following assumptions:

| | Warrants | |
|---|---|---|
| Expected term | 1 year | |
| Volatility | 171.36 | % |
| Risk Free Rate | 0.28 | % |

The proceeds of the Notes were allocated to the components as follows:

| | Proceeds allocated at issue date |
|---|---|
| Private Offering Notes | $ 342,857 |
| Private Offering Warrants | 120,000 |
| Beneficial Conversion feature | 137,143 |
| Total | $ 600,000 |

During the quarter ended December 31, 2015, the Company did an additional private offering of convertible notes and warrants, under which it issued $470,588 of convertible promissory notes for consideration of $400,000, the difference between the proceeds from the notes and principal amount consists of $70,588 of original issue discount. The notes are convertible at an initial conversion price of $0.20 per share any time after issuance thereby having an embedded beneficial conversion feature. The note holders were also issued market-related warrants for 1,176,470 in shares of common stock. The warrants have an exercise price of $0.60 and a 1-year term. The beneficial conversion feature and the warrants were recorded to additional paid-in-capital. The Company allocated the proceeds received to the notes, the beneficial conversion feature and the warrants on a relative fair value basis at the time of issuance. The total debt discount is amortized over the life of the notes to interest expense.

The beneficial conversion feature was valued at the intrinsic value on the issuance date. The intrinsic value represents the difference between the conversion price and the fair value of the common stock multiplied by the number of shares into which the note is convertible. We estimated the fair value of the warrants on the issue date using a Black-Scholes pricing model with the following assumptions:

| | Warrants |
|---|---|
| Expected term | 1 year |

| | | |
|---|---|---|
| Volatility | 132.44 | % |
| Risk Free Rate | 0.66 | % |

The proceeds of the Notes were allocated to the components as follows:

| | Proceeds allocated at issue date |
|---|---|
| Private Offering Notes | $ 361,991 |
| Private Offering Warrants | 38,009 |
| Beneficial Conversion feature | |
| Total | $ 400,000 |

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During the quarter ended March 31, 2016, the Company did an additional private offering of convertible notes and warrants, under which it issued $705,882 of convertible promissory notes for consideration of $600,000, the difference between the proceeds from the notes and principal amount consists of $105,882 of original issue discount. The notes are convertible at an initial conversion price of $0.20 per share any time after issuance thereby having an embedded beneficial conversion feature. The note holders were also issued market-related warrants for 3,529,412 in shares of common stock. The warrants have an exercise price of $0.60 and a 1-year term. The beneficial conversion feature and the warrants were recorded to additional paid-in-capital. The Company allocated the proceeds received to the notes, the beneficial conversion feature and the warrants on a relative fair value basis at the time of issuance. The total debt discount is amortized over the life of the notes to interest expense.

The beneficial conversion feature was valued at the intrinsic value on the issuance date. The intrinsic value represents the difference between the conversion price and the fair value of the common stock multiplied by the number of shares into which the note is convertible. We estimated the fair value of the warrants on the issue date using a Black-Scholes p