ARCH CAPITAL GROUP LTD.
Form 10-Q
May 08, 2008

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, 2008

Or

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period to

Commission file number: **0-26456**

ARCH CAPITAL GROUP LTD.

(Exact name of registrant as specified in its charter)

Bermuda	**Not Applicable**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
Wessex House, 45 Reid Street Hamilton HM 12, Bermuda	
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code: **(441) 278-9250**

(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 o

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

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

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x

Indicate the number of shares outstanding of each of the issuer s classes of common shares as of the latest practicable date.

Class	-	Outstanding at April 30, 2008
Common Shares, $0.01 par value		64,086,081

ARCH CAPITAL GROUP LTD.

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of

Arch Capital Group Ltd.:

We have reviewed the accompanying consolidated balance sheets of Arch Capital Group Ltd. and its subsidiaries (the Company) as of March 31, 2008, and the related consolidated statements of income, changes in shareholders equity, comprehensive income and cash flows for each of the three-month periods ended March 31, 2008 and March 31, 2007. These interim financial statements are the responsibility of the Company s management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet as of December 31, 2007, and the related consolidated statements of income, changes in shareholders equity, comprehensive income, and of cash flows for the year then ended (not presented herein), and in our report dated February 28, 2008, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet information as of December 31, 2007, is fairly stated in all material respects in relation to the consolidated balance sheet from which it has been derived.

/s/ PricewaterhouseCoopers LLP

New York, New York

May 8, 2008

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(U.S. dollars in thousands, except share data)

	(Unaudited) March 31, 2008	December 31, 2007
Assets		
Investments:		
Fixed maturities available for sale, at fair value (amortized cost: 2008, $7,511,224; 2007, $7,037,272)	$7,591,695	$7,137,998
Short-term investments available for sale, at fair value (amortized cost: 2008, $629,249; 2007, $700,262)	631,285	699,036
Short-term investment of funds received under securities lending agreements, at fair value	1,228,868	1,503,723
Other investments (cost: 2008, $308,075; 2007, $323,950)	316,252	353,694
Investment funds accounted for using the equity method	294,379	235,975
Total investments	10,062,479	9,930,426
Cash	258,680	239,915
Accrued investment income	73,686	73,862
Fixed maturities and short-term investments pledged under securities lending agreements, at fair value	1,190,086	1,463,045
Premiums receivable	880,946	729,628
Funds held by reinsureds	72,844	74,752
Unpaid losses and loss adjustment expenses recoverable	1,652,117	1,609,619
Paid losses and loss adjustment expenses recoverable	110,962	132,289
Prepaid reinsurance premiums	419,046	480,462
Deferred income tax assets, net	55,645	57,051
Deferred acquisition costs, net	311,364	290,059
Receivable for securities sold	671,354	17,359
Other assets	595,266	525,800
Total Assets	$16,354,475	$15,624,267
Liabilities		
Reserve for losses and loss adjustment expenses	$7,319,141	$7,092,452
Unearned premiums	1,810,324	1,765,881
Reinsurance balances payable	322,280	301,309
Senior notes	300,000	300,000
Securities lending collateral	1,228,868	1,503,723
Payable for securities purchased	710,994	23,155
Other liabilities	658,324	601,936
Total Liabilities	12,349,931	11,588,456
Commitments and Contingencies		
Shareholders Equity		
Non-cumulative preferred shares ($0.01 par value, 50,000,000 shares authorized)		
- Series A (issued: 2008 and 2007, 8,000,000)	80	80
- Series B (issued: 2008 and 2007, 5,000,000)	50	50
Common shares ($0.01 par value, 200,000,000 shares authorized, issued: 2008, 64,649,618; 2007, 67,318,466)	646	673
Additional paid-in capital	1,269,821	1,451,667
Retained earnings	2,617,539	2,428,117
Accumulated other comprehensive income, net of deferred income tax	116,408	155,224
Total Shareholders Equity	4,004,544	4,035,811
Total Liabilities and Shareholders Equity	$16,354,475	$15,624,267

See Notes to Consolidated Financial Statements

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(U.S. dollars in thousands, except share data)

	(Unaudited) Three Months Ended March 31,	
	2008	**2007**
Revenues		
Net premiums written	$811,342	$871,745
Increase in unearned premiums	(103,108)	(126,252)
Net premiums earned	708,234	745,493
Net investment income	122,193	110,047
Net realized gains (losses)	35,975	(981)
Fee income	1,068	1,969
Equity in net income (loss) of investment funds accounted for using the equity method	(22,313)	2,642
Other income	4,036	604
Total revenues	849,193	859,774
Expenses		
Losses and loss adjustment expenses	404,417	420,061
Acquisition expenses	114,639	120,128
Other operating expenses	97,187	90,813
Interest expense	5,524	5,523
Net foreign exchange losses	23,587	9,742
Total expenses	645,354	646,267
Income before income taxes	203,839	213,507
Income tax expense	7,956	8,495
Net income	195,883	205,012
Preferred dividends	6,461	6,461
Net income available to common shareholders	$189,422	$198,551
Net income per common share		
Basic	$2.90	$2.69
Diluted	$2.78	$2.59
Weighted average common shares and common share equivalents outstanding		
Basic	65,295,516	73,931,996
Diluted	68,019,413	76,640,686

See Notes to Consolidated Financial Statements

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY

(U.S. dollars in thousands)

	(Unaudited) Three Months Ended March 31,	
	2008	**2007**
Non-Cumulative Preferred Shares		
Balance at beginning and end of period	$130	$130
Common Shares		
Balance at beginning of year	673	743
Common shares issued, net	0	1
Purchases of common shares under share repurchase program	(27)	(7)
Balance at end of period	646	737
Additional Paid-in Capital		
Balance at beginning of year	1,451,667	1,944,304
Common shares issued	0	109
Exercise of stock options	3,749	6,997
Common shares retired	(190,278)	(46,291)
Amortization of share-based compensation	4,600	4,306
Other	83	700
Balance at end of period	1,269,821	1,910,125
Retained Earnings		
Balance at beginning of year	2,428,117	1,593,907
Adjustment to adopt SFAS No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140		2,111
Balance at beginning of year, as adjusted	2,428,117	1,596,018
Dividends declared on preferred shares	(6,461)	(6,461)
Net income	195,883	205,012
Balance at end of period	2,617,539	1,794,569
Accumulated Other Comprehensive Income		
Balance at beginning of year	155,224	51,535
Adjustment to adopt SFAS No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140		(2,111)
Balance at beginning of year, as adjusted	155,224	49,424
Change in unrealized appreciation (decline) in value of investments, net of deferred income tax	(37,577)	20,587
Foreign currency translation adjustments, net of deferred income tax	(1,239)	7,776
Balance at end of period	116,408	77,787
Total Shareholders Equity	$4,004,544	$3,783,348

See Notes to Consolidated Financial Statements

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(U.S. dollars in thousands)

	(Unaudited) Three Months Ended March 31,	
	2008	**2007**
Comprehensive Income		
Net income	$195,883	$205,012
Other comprehensive income (loss), net of deferred income tax		
Unrealized decline in value of investments:		
Unrealized holding gains arising during period	12,707	22,014
Reclassification of net realized gains, net of income taxes, included in net income	(50,284)	(1,427)
Foreign currency translation adjustments	(1,239)	7,776
Other comprehensive (loss) income	(38,816)	28,363
Comprehensive Income	$157,067	$233,375

See Notes to Consolidated Financial Statements

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(U.S. dollars in thousands)

	(Unaudited) Three Months Ended March 31,	
	2008	**2007**
Operating Activities		
Net income	$195,883	$205,012
Adjustments to reconcile net income to net cash provided by operating activities:		
Net realized (gains) losses	(33,791)	1,097
Equity in net (income) loss of investment funds accounted for using the equity method and other income	18,277	(3,246)
Share-based compensation	4,600	4,306
Changes in:		
Reserve for losses and loss adjustment expenses, net of unpaid losses and loss adjustment expenses recoverable	182,498	147,462
Unearned premiums, net of prepaid reinsurance premiums	105,497	127,107
Premiums receivable	(148,197)	(203,707)
Deferred acquisition costs, net	(21,319)	(23,700)
Funds held by reinsureds	1,908	21,602
Reinsurance balances payable	19,677	91,498
Other liabilities	40,490	1,296
Other items, net	(30,978)	34,404
Net Cash Provided By Operating Activities	334,545	403,131
Investing Activities		
Purchases of fixed maturity investments	(3,772,652)	(5,047,868)
Proceeds from sales of fixed maturity investments	3,523,338	4,326,607
Proceeds from redemptions and maturities of fixed maturity investments	136,932	183,984
Purchases of other investments	(146,815)	(151,978)
Proceeds from sales of other investments	65,226	54,754
Net sales of short-term investments	74,201	188,663
Change in securities lending collateral	274,855	(268,722)
Purchases of furniture, equipment and other	(3,045)	(4,138)
Net Cash Provided By (Used For) Investing Activities	152,040	(718,698)
Financing Activities		
Purchases of common shares under share repurchase program	(189,843)	(44,475)
Proceeds from common shares issued, net	2,540	3,145
Change in securities lending collateral	(274,855)	268,722
Excess tax benefits from share-based compensation	660	2,355
Preferred dividends paid	(6,461)	(6,461)
Net Cash (Used For) Provided By Financing Activities	(467,959)	223,286
Effects of exchange rate changes on foreign currency cash	139	513
Increase (decrease) in cash	18,765	(91,768)
Cash beginning of year	239,915	317,017
Cash end of period	$258,680	$225,249
Income taxes paid, net	$2,510	$596
Interest paid		

See Notes to Consolidated Financial Statements

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. General

Arch Capital Group Ltd. (ACGL) is a Bermuda public limited liability company which provides insurance and reinsurance on a worldwide basis through its wholly owned subsidiaries.

The interim consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (GAAP) and include the accounts of ACGL and its wholly owned subsidiaries (together with ACGL, the Company). All significant intercompany transactions and balances have been eliminated in consolidation. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and assumptions. In the opinion of management, the accompanying unaudited interim consolidated financial statements reflect all adjustments (consisting of normally recurring accruals) necessary for a fair statement of results on an interim basis. The results of any interim period are not necessarily indicative of the results for a full year or any future periods.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted; however, management believes that the disclosures are adequate to make the information presented not misleading. This report should be read in conjunction with the Company s Annual Report on Form 10-K for the year ended December 31, 2007, including the Company s audited consolidated financial statements and related notes and the section entitled Risk Factors.

To facilitate period-to-period comparisons, certain amounts in the 2007 consolidated financial statements have been reclassified to conform to the 2008 presentation. Such reclassifications had no effect on the Company s consolidated net income.

2. Share Transactions

Share Repurchase Program

On February 28, 2007, ACGL s board of directors authorized the investment of up to $1 billion in ACGL s common shares through a share repurchase program. Repurchases under the program may be effected from time to time in open market or privately negotiated transactions through February 2009. During the 2008 first quarter, ACGL repurchased approximately 2.7 million common shares under the share repurchase program for an aggregate purchase price of $189.8 million. Since the inception of the share repurchase program, ACGL has repurchased approximately 10.5 million common shares for an aggregate purchase price of $726.9 million. As a result of the share repurchase transactions, book value per common share was reduced by $1.70 per share at March 31, 2008 and weighted average shares outstanding for the 2008 first quarter were reduced by 9.4 million shares. The timing and amount of the repurchase transactions under this program will depend on a variety of factors, including market conditions and corporate and regulatory considerations. In connection with the repurchase program, the Warburg Pincus funds waived their rights relating to share repurchases under its shareholders agreement with ACGL for all repurchases of common

shares by ACGL under the repurchase program in open market transactions and certain privately negotiated transactions.

Non-Cumulative Preferred Shares

During 2006, ACGL completed two public offerings of non-cumulative preferred shares (Preferred Shares). On February 1, 2006, $200.0 million principal amount of 8.0% series A non-cumulative preferred shares (Series A Preferred Shares) were issued with net proceeds of $193.5 million and, on May 24, 2006, $125.0 million principal amount of 7.875% series B non-cumulative preferred shares (Series B Preferred Shares) were issued with net proceeds of $120.9 million. The net proceeds of the offerings were used to

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

support the underwriting activities of ACGL s insurance and reinsurance subsidiaries. ACGL has the right to redeem all or a portion of each series of Preferred Shares at a redemption price of $25.00 per share on or after (1) February 1, 2011 for the Series A Preferred Shares and (2) May 15, 2011 for the Series B Preferred Shares. Dividends on the Preferred Shares are non-cumulative. Consequently, in the event dividends are not declared on the Preferred Shares for any dividend period, holders of Preferred Shares will not be entitled to receive a dividend for such period, and such undeclared dividend will not accrue and will not be payable. Holders of Preferred Shares will be entitled to receive dividend payments only when, as and if declared by ACGL s board of directors or a duly authorized committee of the board of directors. Any such dividends will be payable from the date of original issue on a non-cumulative basis, quarterly in arrears. To the extent declared, these dividends will accumulate, with respect to each dividend period, in an amount per share equal to 8.0% of the $25.00 liquidation preference per annum for the Series A Preferred Shares and 7.875% of the $25.00 liquidation preference per annum for the Series B Preferred Shares. At March 31, 2008, the Company had declared an aggregate of $3.3 million of dividends to be paid to holders of the Preferred Shares.

Share-Based Compensation

As required by the provisions of Financial Accounting Standards Board (FASB) Statement No. 123 (revised 2004), Share-Based Payment (SFAS No. 123(R)), the Company recorded after-tax share-based compensation expense related to stock options in the 2008 first quarter of $1.1 million, or $0.02 per diluted share, compared to $1.6 million, or $0.02 per diluted share, in the 2007 first quarter.

3. Debt and Financing Arrangements

Senior Notes

On May 4, 2004, ACGL completed a public offering of $300 million principal amount of 7.35% senior notes (Senior Notes) due May 1, 2034 and received net proceeds of $296.4 million. ACGL used $200 million of the net proceeds to repay all amounts outstanding under a revolving credit agreement. The Senior Notes are ACGL s senior unsecured obligations and rank equally with all of its existing and future senior unsecured indebtedness. Interest payments on the Senior Notes are due on May 1st and November 1st of each year. ACGL may redeem the Senior Notes at any time and from time to time, in whole or in part, at a make-whole redemption price. For the 2008 and 2007 first quarters, interest expense on the Senior Notes was approximately $5.5 million. The fair value of the Senior Notes at March 31, 2008 and December 31, 2007 was $285.2 million and $325.4 million, respectively.

Letter of Credit and Revolving Credit Facilities

As of March 31, 2008, the Company had a $300 million unsecured revolving loan and letter of credit facility and a $1.0 billion secured letter of credit facility (the Credit Agreement). The $300 million unsecured revolving loan is also available for the issuance of unsecured letters of credit up to $100 million for Arch Reinsurance Company (Arch Re U.S.). Borrowings of revolving loans may be made by ACGL and Arch Re U.S. at a variable rate based on LIBOR or an alternative base rate at the option of the Company. Secured letters of credit are available for issuance on

behalf of the Company s insurance and reinsurance subsidiaries. Issuance of letters of credit and borrowings under the Credit Agreement are subject to the Company s compliance with certain covenants and conditions, including absence of a material adverse change. These covenants require, among other things, that the Company maintain a debt to shareholders equity ratio of not greater than 0.35 to 1 and shareholders equity in excess of $1.95 billion plus 25% of future aggregate net income for each quarterly period (not including any future net losses) beginning after June 30, 2006 and 25% of future aggregate proceeds from the issuance of common or preferred equity and that the Company s principal insurance and reinsurance subsidiaries maintain at least a B++ rating from A.M. Best. In addition, certain of the Company s subsidiaries which are party to the Credit Agreement are required to maintain minimum shareholders equity levels. The

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Company was in compliance with all covenants contained in the Credit Agreement at December 31, 2007. The Credit Agreement expires on August 30, 2011.

Including the secured letter of credit portion of the Credit Agreement and another letter of credit facility (together, the LOC Facilities), the Company has access to letter of credit facilities for up to a total of $1.45 billion. The principal purpose of the LOC Facilities is to issue, as required, evergreen standby letters of credit in favor of primary insurance or reinsurance counterparties with which the Company has entered into reinsurance arrangements to ensure that such counterparties are permitted to take credit for reinsurance obtained from the Company s reinsurance subsidiaries in United States jurisdictions where such subsidiaries are not licensed or otherwise admitted as an insurer, as required under insurance regulations in the United States, and to comply with requirements of Lloyd s of London in connection with qualifying quota share and other arrangements. The amount of letters of credit issued is driven by, among other things, the timing and payment of catastrophe losses, loss development of existing reserves, the payment pattern of such reserves, the further expansion of the Company s business and the loss experience of such business. When issued, certain letters of credit are secured by a portion of the Company s investment portfolio. In addition, the LOC Facilities also require the maintenance of certain covenants, which the Company was in compliance with at March 31, 2008. At such date, the Company had approximately $579.9 million in outstanding letters of credit under the LOC Facilities, which were secured by investments totaling $612.2 million. It is anticipated that the LOC Facilities will be renewed (or replaced) on expiry, but such renewal (or replacement) will be subject to the availability of credit from banks which the Company utilizes. In addition to letters of credit, the Company has and may establish insurance trust accounts in the U.S. and Canada to secure its reinsurance amounts payable as required.

4. Segment Information

The Company classifies its businesses into two underwriting segments insurance and reinsurance and corporate and other (non-underwriting). The Company s insurance and reinsurance operating segments each have segment managers who are responsible for the overall profitability of their respective segments and who are directly accountable to the Company s chief operating decision makers, the President and Chief Executive Officer of ACGL and the Chief Financial Officer of ACGL. The chief operating decision makers do not assess performance, measure return on equity or make resource allocation decisions on a line of business basis. The Company determined its reportable operating segments using the management approach described in SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information.

Management measures segment performance based on underwriting income or loss. The Company does not manage its assets by segment and, accordingly, investment income is not allocated to each underwriting segment. In addition, other revenue and expense items are not evaluated by segment. The accounting policies of the segments are the same as those used for the preparation of the Company s consolidated financial statements. Intersegment business is allocated to the segment accountable for the underwriting results.

The insurance segment consists of the Company s insurance underwriting subsidiaries which primarily write on both an admitted and non-admitted basis. The insurance segment consists of nine product lines: casualty; construction and national accounts; executive assurance; healthcare; professional liability; programs; property, marine and aviation; surety; and other (consisting of collateral protection, excess workers compensation and employers liability business and travel and accident business).

The reinsurance segment consists of the Company s reinsurance underwriting subsidiaries. The reinsurance segment generally seeks to write significant lines on specialty property and casualty reinsurance treaties. Classes of business include: casualty; marine and aviation; other specialty; property catastrophe; property excluding property catastrophe (losses on a single risk, both excess of loss and pro rata); and other (consisting of non-traditional and casualty clash business).

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Corporate and other (non-underwriting) includes net investment income, other fee income, net of related expenses, other income (loss), other expenses incurred by the Company, interest expense, net realized gains or losses, equity in net income (loss) of investment funds accounted for using the equity method, net foreign exchange gains or losses and income taxes. In addition, corporate and other results include dividends on the Company s non-cumulative preferred sharesThe following tables set forth an analysis of the Company s underwriting income by segment, together with a reconciliation of underwriting income to net income available to common shareholders:

	Three Months Ended March 31, 2008		
(U.S. dollars in thousands)	**Insurance**	**Reinsurance**	**Total**
Gross premiums written **(1)**	$626,348	$433,827	$1,053,152
Net premiums written **(1)**	402,764	408,578	811,342
Net premiums earned **(1)**	$419,100	$289,134	$708,234
Fee income	882	186	1,068
Losses and loss adjustment expenses	(287,303)	(117,114)	(404,417)
Acquisition expenses, net	(51,889)	(62,750)	(114,639)
Other operating expenses	(73,637)	(18,238)	(91,875)
Underwriting income	$7,153	$91,218	98,371
Net investment income			122,193
Net realized gains			35,975
Equity in net income (loss) of investment funds accounted for using the equity method			(22,313)
Other income			4,036
Other expenses			(5,312)
Interest expense			(5,524)
Net foreign exchange losses			(23,587)
Income before income taxes			203,839
Income tax expense			(7,956)
Net income			195,883
Preferred dividends			(6,461)
Net income available to common shareholders			$189,422
Underwriting Ratios			
Loss ratio	68.6%	40.5%	57.1%
Acquisition expense ratio **(2)**	12.2%	21.7%	16.1%
Other operating expense ratio	17.6%	6.3%	13.0%
Combined ratio	98.4%	68.5%	86.2%

(1) Certain amounts included in the gross premiums written of each segment are related to intersegment transactions. Accordingly, the sum of gross premiums written for each segment does not agree to the total gross premiums written as shown in the table above due to the elimination of intersegment transactions in the total. The insurance segment results include $7.0 million of gross and net premiums written and $8.7 million of net premiums earned assumed through intersegment transactions. The reinsurance segment results include $0.1 million of net premiums earned assumed through intersegment transactions.

(2) The acquisition expense ratio is adjusted to include policy-related fee income.

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(U.S. dollars in thousands)	Three Months Ended March 31, 2007 Insurance	Reinsurance	Total
Gross premiums written **(1)**	$661,210	$558,654	$1,210,614
Net premiums written **(1)**	428,344	443,401	871,745
Net premiums earned **(1)**	$413,847	$331,646	$745,493
Fee income	1,425	544	1,969
Losses and loss adjustment expenses	(259,322)	(160,739)	(420,061)
Acquisition expenses, net	(46,695)	(73,433)	(120,128)
Other operating expenses	(68,894)	(13,781)	(82,675)
Underwriting income	$40,361	$84,237	124,598
Net investment income			110,047
Net realized losses			(981)
Equity in net income (loss) of investment funds accounted for using the equity method			2,642
Other income			604
Other expenses			(8,138)
Interest expense			(5,523)
Net foreign exchange losses			(9,742)
Income before income taxes			213,507
Income tax expense			(8,495)
Net income			205,012
Preferred dividends			(6,461)
Net income available to common shareholders			$198,551
Underwriting Ratios			
Loss ratio	62.7%	48.5%	56.3%
Acquisition expense ratio **(2)**	11.1%	22.1%	16.0%
Other operating expense ratio	16.6%	4.2%	11.1%
Combined ratio	90.4%	74.8%	83.4%

(1) Certain amounts included in the gross premiums written of each segment are related to intersegment transactions. Accordingly, the sum of gross premiums written for each segment does not agree to the total gross premiums written as shown in the table above due to the elimination of intersegment transactions in the total. The insurance segment and reinsurance segment results include $0.5 million and $8.7 million, respectively, of gross and net premiums written and $0.5 million and $10.6 million, respectively, of net premiums earned assumed through intersegment transactions.

(2) The acquisition expense ratio is adjusted to include certain fee income.

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Set forth below is summary information regarding net premiums written and earned by major line of business and net premiums written by client location for the insurance segment:

	Three Months Ended March 31,			
	2008		2007	
INSURANCE SEGMENT (U.S. dollars in thousands)	**Amount**	**% of Total**	**Amount**	**% of Total**
Net premiums written (1)				
Property, marine and aviation	$98,162	24.4	$84,863	19.8
Construction and national accounts	61,211	15.2	60,483	14.1
Programs	54,583	13.5	58,323	13.6
Professional liability	54,081	13.4	58,355	13.6
Executive assurance	42,169	10.5	44,091	10.3
Casualty	27,618	6.9	43,091	10.1
Healthcare	10,997	2.7	21,530	5.0
Surety	10,867	2.7	18,747	4.4
Other **(2)**	43,076	10.7	38,861	9.1
Total	$402,764	100.0	$428,344	100.0
Net premiums earned (1)				
Property, marine and aviation	$84,992	20.3	$81,804	19.8
Construction and national accounts	57,115	13.6	47,975	11.6
Programs	56,987	13.6	56,209	13.6
Professional liability	68,810	16.4	67,884	16.4
Executive assurance	44,408	10.6	45,378	11.0
Casualty	41,772	10.0	51,542	12.4
Healthcare	13,445	3.2	19,844	4.8
Surety	13,499	3.2	19,129	4.6
Other **(2)**	38,072	9.1	24,082	5.8
Total	$419,100	100.0	$413,847	100.0
Net premiums written by client location (1)				
United States	$279,255	69.3	$320,005	74.7
Europe	86,300	21.4	74,935	17.5
Other	37,209	9.3	33,404	7.8
Total	$402,764	100.0	$428,344	100.0
Net premiums written by underwriting location (1)				
United States	$287,207	71.3	$331,557	77.4
Europe	102,011	25.3	82,016	19.1
Other	13,546	3.4	14,771	3.5
Total	$402,764	100.0	$428,344	100.0

(1) Insurance segment results include premiums earned assumed through intersegment transactions of $0.1 million for the 2008 first quarter and premiums written and earned assumed of $0.5 million and $0.5 million, respectively, for

the 2007 first quarter. Insurance segment results exclude premiums written and earned ceded through intersegment transactions of $7.0 million and $8.7 million, respectively, for the 2008 first quarter and $8.7 million and $10.6 million, respectively, for the 2007 first quarter.

(2) Includes excess workers compensation and employers liability business and travel and accident business.

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table sets forth the reinsurance segment s net premiums written and earned by major line of business and type of business, together with net premiums written by client location:

	Three Months Ended March 31,			
	2008		2007	
REINSURANCE SEGMENT (U.S. dollars in thousands)	**Amount**	**% of Total**	**Amount**	**% of Total**
Net premiums written (1)				
Property catastrophe	$106,224	26.0	$80,659	18.2
Casualty **(2)**	105,987	26.0	144,476	32.6
Property excluding property catastrophe **(3)**	95,922	23.5	94,944	21.4
Other specialty	75,680	18.5	73,996	16.7
Marine and aviation	22,164	5.4	43,715	9.8
Other	2,601	0.6	5,611	1.3
Total	$408,578	100.0	$443,401	100.0
Net premiums earned (1)				
Property catastrophe	$50,281	17.4	$34,691	10.5
Casualty **(2)**	107,648	37.2	140,444	42.4
Property excluding property catastrophe **(3)**	63,341	21.9	73,039	22.0
Other specialty	38,484	13.3	52,042	15.7
Marine and aviation	27,431	9.5	26,622	8.0
Other	1,949	0.7	4,808	1.4
Total	$289,134	100.0	$331,646	100.0
Net premiums written (1)				
Pro rata	$215,419	52.7	$263,815	59.5
Excess of loss	193,159	47.3	179,586	40.5
Total	$408,578	100.0	$443,401	100.0
Net premiums earned (1)				
Pro rata	$192,076	66.4	$242,439	73.1
Excess of loss	97,058	33.6	89,207	26.9
Total	$289,134	100.0	$331,646	100.0

	for Unused	Health Insurance	Life Insurance	Disability Insurance	Employer (f) Matching	Other	Total All

Named Executive Officer	Year	Vacation	Premiums	Premiums	Premiums	Contributions	Benefits	Other Compensation
David C. Bupp (f)	2011	$ 3,584	$ 227	$ 1,002	$ 213	$ 4,169	$ 772	$ 9,967
	2010	—	—	1,792	594	4,900	2,195	8,887
	2009	—	—	1,792	594	4,900	1,929	8,621
Mark J. Pykett, V.M.D., Ph.D. (g)	2011	$ —	$ 1,019	$ 2,003	$ 640	$ 3,769	$ —	$ 7,431
	2010	—	—	—	—	—	—	—
	2009	—	—	—	—	—	—	—
Rodger A. Brown	2011	$ 4,769	$ 694	$ 1,081	$ 552	$ —	$ —	$ 7,096
	2010	—	—	910	460	—	—	910
	2009	—	—	857	434	—	—	1,079
Frederick O. Cope, Ph.D. (h)	2011	$ 4,818	$ 678	$ 1,405	$ 640	$ 4,900	$ —	$ 12,441
	2010	—	—	1,229	594	4,751	—	5,980
	2009	—	—	851	446	3,509	—	4,360
Brent L. Larson	2011	$ 2,531	$ 1,019	$ 1,348	$ 640	$ 4,900	$ —	$ 10,438
	2010	—	—	1,138	579	4,595	—	5,733
	2009	—	—	1,079	546	4,008	—	4,934
Thomas H. Tulip, Ph.D. (i)	2011	$ —	$ 2,807	$ 650	$ 320	$ 2,901	$ —	$ 6,678
	2010	—	—	—	—	—	—	—
	2009	—	—	—	—	—	—	—

(a) Amount represents payment for unused vacation time in excess of the amount eligible for rollover in fiscal 2011. The amount paid is calculated based on the employee's salary in effect at the end of the fiscal year to which the unused vacation time relates.

(b) Amount represents reimbursement of the lost tax benefit due to the ineligibility of our Named Executive Officers to pay their portion of medical, dental, and vision premiums on a pre-tax basis under our IRC Section 125 Plan.

(c) Amount represents group life insurance premiums paid on behalf of the Named Executive Officers.

(d) Amount represents group long-term disability insurance premiums paid on behalf of the Named Executive Officers.

(e) Amount represents the value of the common stock contributed to the Named Executive Officer's account in our 401(k) Plan as calculated on a quarterly basis.

(f) During his tenure as Chief Executive Officer, the Company reimbursed Mr. Bupp for membership dues at a private club where Mr. Bupp often conducted business meetings.

(g) Mr. Bupp retired from service as our President and Chief Executive Officer effective April 15, 2011.

(h) Dr. Pykett commenced employment with the Company effective November 15, 2010, and was promoted to President and Chief Executive Officer effective April 15, 2011.

(i) Dr. Cope commenced employment with the Company effective February 16, 2009.

(j) Dr. Tulip commenced employment with the Company effective June 1, 2011.

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Grants of Plan-Based Awards

The following table sets forth certain information about plan-based awards that we made to the Named Executive Officers during fiscal 2011. For information about the plans under which these awards were granted, see the discussion under "Short-Term Incentive Compensation" and "Long-Term Incentive Compensation" in the "Compensation Discussion and Analysis" section above.

Grants of Plan-Based Awards Table for Fiscal 2011

Named Executive Officer	Grant Date	Estimated Future Payouts Under Non-Equity Incentive Plan Awards (a)		Estimated Future Payouts Under Equity Incentive Plan Awards (b)		All Other Stock Awards: Number of Shares of Stock	All Other Option Awards: Number of Securities Underlying Options	Exercise Price of Option Awards	Grant Date Fair Value of Stock and Option Awards	
		Threshold	Maximum	Threshold	Maximum					
David C. Bupp	N/A	$ —	$ 60,000	—	—	—	—	$ —	$ —	(a)
Mark J. Pykett, V.M.D., Ph.D.	N/A	$ —	$ 180,377	—	—	—	—	—	$ —	(a)
	4/15/2011	$ —	$ —	—	50,000	—	—	$ —	$ 201,450	(c)
Rodger A. Brown	N/A	$ —	$ 30,000	—	—	—	—	$ —	$ —	(a)
Frederick O. Cope ,Ph.D.	N/A	$ —	$ 65,000	—	—	—	—	$ —	$ —	(a)
Brent L. Larson	N/A	$ —	$ 45,000	—	—	—	—	$ —	$ —	(a)
Thomas H. Tulip, Ph.D.	N/A	$ —	$ 61,562	—	—	—	—	—	$ —	(a)
	6/1/2011	$ —	$ —	—	80,000	—	—	—	$ 394,320	(d)
	6/1/2011	$ —	$ —	—	—	—	110,000	$ 4.93	$ 346,842	(e)

(a) The threshold amount reflects the fact that no cash bonus awards would have been payable if none of the specified business performance objectives were achieved. The maximum amount reflects the target cash bonus awards

payable if all of the specified business performance objectives are achieved. For actual cash bonus award amounts, see the "Non-Equity Incentive Plan Compensation" column in the Summary Compensation table above.

(b) The threshold amount reflects the fact that no restricted stock awards will be payable if none of the vesting terms are achieved. The maximum amount reflects the target restricted stock awards payable if all of the vesting terms are achieved.

(c) These shares of restricted stock will vest upon the first regulatory approval of a Lymphoseek product by either FDA or EMA, or upon the occurrence of a change in control as defined in the restricted stock agreement. If the employment of Dr. Pykett with the Company is terminated for reasons other than a change in control before all of the restricted shares have vested, then pursuant to the terms of the restricted stock agreements all restricted shares that have not vested at the effective date of Dr. Pykett's termination shall immediately be forfeited by Dr. Pykett.

(d) These shares of restricted stock will vest according to the following terms:

- 20,000 of the restricted shares vested upon the completion of the AstraZeneca license agreement on December 9, 2011;
- 20,000 will vest upon the partnering of Lymphoseek in Europe covering at least four countries;
- 20,000 will vest upon the partnering of Lymphoseek in Asia covering either Japan or at least two other countries; and
- 20,000 will vest upon the achievement of annual revenue to the Company from Cardinal Health, Inc. related to Lymphoseek of over $2 million per month for three consecutive months following the receipt of commercial marketing clearance in the U.S., if achieved before the 24th month following such marketing clearance.

All of Dr. Tulip's restricted shares vest upon the occurrence of a change in control as defined in Dr. Tulip's employment agreement, or if Dr. Tulip is terminated without cause as defined in his employment agreement. If the employment of Dr. Tulip with the Company is terminated for reasons other than a change in control or termination without cause before all of the restricted shares have vested, then pursuant to the terms of the restricted stock agreement all restricted shares that have not vested at the effective date of Dr. Tulip's termination shall immediately be forfeited by Dr. Tulip.

(e) These stock options vest as to one-fourth on each of the first four anniversaries of the date of grant, and expire on the tenth anniversary of the date of grant. If the employment of Dr. Tulip with the Company is terminated due to a change in control or without cause before all of the stock options have vested, then pursuant to the terms of the Stock Option Award Agreement all stock options that have not vested at the effective date of Dr. Tulip's termination shall immediately vest and become exercisable.

Outstanding Equity Awards

The following table presents certain information concerning outstanding equity awards held by the Named Executive Officers as of December 31, 2011.

Outstanding Equity Awards Table at Fiscal 2011 Year-End

	Option Awards					Stock Awards Equity Incentive Plan Awards		
Named Executive Officer	Number of Securities Underlying Unexercised Options (#) Exercisable	Unexercisable	Option Exercise Price	Option Expiration Date	Note	Number of Unearned Shares	Market Value of Unearned **Shares (s)**	Note
David C. Bupp						300,000	$ 786,000	(m)
Mark J. Pykett, V.M.D., Ph.D.	66,667	133,333	$ 1.70	11/12/2010	(j)	300,000	$ 786,000	(p)
						50,000	$ 131,000	(q)
Rodger A. Brown	50,000	—	$ 0.49	7/28/2014	(b)	20,000	$ 52,400	(m)
	40,000	—	$ 0.39	12/10/2014	(c)	25,000	$ 65,500	(o)
	20,000	—	$ 0.26	12/27/2015	(d)			
	20,000	—	$ 0.27	12/15/2016	(e)			
	20,000	—	$ 0.362	1/3/2018	(f)			
	16,667	8,333	$ 0.59	1/5/2019	(g)			
	33,333	16,667	$ 1.10	10/30/2019	(i)			
	15,000	45,000	$ 1.90	12/21/2020	(k)			
Frederick O. Cope, Ph.D.	33,333	16,667	$ 0.65	2/16/2019	(h)	100,000	$ 262,000	(n)
	50,000	25,000	$ 1.10	10/30/2019	(i)	75,000	$ 196,500	(o)
	30,000	90,000	$ 1.90	12/21/2020	(k)			
Brent L. Larson	70,000	—	$ 0.30	1/7/2014	(a)	50,000	$ 131,000	(m)
	50,000	—	$ 0.49	7/28/2014	(b)	75,000	$ 196,500	(o)
	50,000	—	$ 0.39	12/10/2014	(c)			
	40,000	—	$ 0.26	12/27/2015	(c)			
	50,000	—	$ 0.27	12/15/2016	(e)			
	50,000	—	$ 0.362	1/3/2018	(f)			
	16,667	8,333	$ 0.59	1/5/2019	(g)			
	50,000	25,000	$ 1.10	10/30/2019	(i)			
	23,750	71,250	$ 1.90	12/21/2020	(k)			

Thomas H. Tulip, Ph.D.	—	110,000	$ 4.93	6/1/2011	(l)	60,000	$ 157,200	(r)

(a) Options were granted 1/7/2004 and vested as to one-third on each of the first three anniversaries of the date of grant.

(b) Options were granted 7/28/2004 and vested as to one-third on each of the first three anniversaries of the date of grant.

(c) Options were granted 12/10/2004 and vested as to one-third on each of the first three anniversaries of the date of grant.

(d) Options were granted 12/27/2005 and vested as to one-third immediately and on each of the first two anniversaries of the date of grant.

(e) Options were granted 12/15/2006 and vested as to one-third on each of the first three anniversaries of the date of grant.

(f) Options were granted 1/3/2008 and vested as to one-third on each of the first three anniversaries of the date of grant.

(g) Options were granted 1/5/2009 and vest as to one-third on each of the first three anniversaries of the date of grant.

(h) Options were granted 2/16/2009 and vest as to one-third on each of the first three anniversaries of the date of grant.

(i) Options were granted 10/30/2009 and vest as to one-third on each of the first three anniversaries of the date of grant.

(j) Options were granted 11/12/2010 and vest as to one-third on each of the first three anniversaries of the date of grant.

(k) Options were granted 12/21/2010 and vest as to one-fourth on each of the first four anniversaries of the date of grant.

(l) Options were granted 6/1/2011 and vest as to one-fourth on each of the first four anniversaries of the date of grant.

(m) Restricted shares granted January 3, 2008. Pursuant to the terms of restricted stock agreements between the Company and each grantee, the restricted shares will vest upon the approval of a NDA for Lymphoseek by FDA. If the employment of a grantee with the Company is terminated before all of the restricted shares have vested, then pursuant to the terms of the restricted stock agreements all restricted shares that have not vested at the effective date of such grantee’s termination shall immediately be forfeited by the grantee. Pursuant to its authority under Section 3.2 of the restricted stock agreements the CNG Committee eliminated the forfeiture provision in Section 3.2(b) of the restricted stock agreements effective January 1, 2009, which provision effected the forfeiture of the shares if the vesting event did not occur before June 30, 2010.

(n) Restricted shares granted February 16, 2009. Pursuant to the terms of the restricted stock agreement between the Company and Dr. Cope, 50% of the restricted shares will vest upon the approval of a NDA for Lymphoseek by FDA or the approval of marketing authorization for Lymphoseek by EMA and 50% of the restricted shares will vest upon the commencement of patient enrollment in a Phase 3 clinical trial in humans of RIGScan. All of the restricted shares vest upon the occurrence of a change in control as defined in Dr. Cope's employment agreement. If the employment of Dr. Cope with the Company is terminated for reasons other than a change in control before all of the restricted shares have vested, then pursuant to the terms of the restricted stock agreement all restricted shares that have not vested at the effective date of Dr. Cope's termination shall immediately be forfeited by Dr. Cope.

(o) Restricted shares granted December 1, 2009. Pursuant to the terms of restricted stock agreements between the Company and each grantee, the restricted shares will vest upon the approval of a NDA for Lymphoseek by FDA or the approval of marketing authorization for Lymphoseek by EMA. All of the restricted shares vest upon the occurrence of a change in control as defined in the restricted stock agreement. If the employment of a grantee with the Company is terminated for reasons other than a change in control before all of the restricted shares have vested, then pursuant to the terms of the restricted stock agreements all restricted shares that have not vested at the effective date of such grantee's termination shall immediately be forfeited by the grantee.

(p) Restricted shares granted November 15, 2010. Pursuant to the terms of the restricted stock agreement between the Company and Dr. Pykett, 125,000 of the restricted shares will vest upon the approval of a NDA for Lymphoseek by FDA or the approval of marketing authorization for Lymphoseek by EMA and 175,000 of the restricted shares will vest upon the approval of a NDA for a RIGS technology product by FDA or the approval of marketing authorization for a RIGS technology product by EMA. All of the restricted shares vest upon the occurrence of a change in control as defined in Dr. Pykett's employment agreement, or if Dr. Pykett is terminated without cause as defined in his employment agreement. If the employment of Dr. Pykett with the Company is terminated for reasons other than a change in control or without cause before all of the restricted shares have vested, then pursuant to the terms of the restricted stock agreement all restricted shares that have not vested at the effective date of Dr. Pykett's termination shall immediately be forfeited by Dr. Pykett.

(q) Restricted shares granted April 15, 2011. Pursuant to the terms of the restricted stock agreement between the Company and Dr. Pykett, the restricted shares will vest upon the first regulatory approval of a Lymphoseek product by either FDA or EMA. All of the restricted shares vest upon the occurrence of a change in control as defined in the restricted stock agreement. If the employment of Dr. Pykett with the Company is terminated for reasons other than a change in control before all of the restricted shares have vested, then pursuant to the terms of the restricted stock agreements all restricted shares that have not vested at the effective date of Dr. Pykett's termination shall immediately be forfeited by Dr. Pykett.

(r) Restricted shares granted June 1, 2011. Pursuant to the terms of the restricted stock agreement between the Company and Dr. Tulip, 20,000 of the restricted shares vested upon the completion of the AstraZeneca license agreement on December 9, 2011, 20,000 will vest upon the partnering of Lymphoseek in Europe covering at least four countries, 20,000 will vest upon the partnering of Lymphoseek in Asia covering either Japan or at least two other countries, and 20,000 will vest upon the achievement of annual revenue to the Company from Cardinal Health, Inc. related to Lymphoseek of over $2 million per month for three consecutive months following the receipt of commercial marketing clearance in the U.S., if achieved before the 24th month following such marketing clearance. All of the restricted shares vest upon the occurrence of a change in control as defined in Dr. Tulip's employment agreement, or if Dr. Tulip is terminated without cause as defined in his employment agreement. If the employment of Dr. Tulip with the Company is terminated for reasons other than a change in control or without cause before all of the restricted shares have vested, then pursuant to the terms of the restricted stock agreement all restricted shares that have not vested at the effective date of Dr. Tulip's termination shall immediately be forfeited by Dr. Tulip.

(s) Estimated by reference to the closing market price of the Company's common stock on December 31, 2011, pursuant to Instruction 3 to Item 402(p)(2) of Regulation S-K. The closing price of the Company's common stock

on December 31, 2011, was $2.62.

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Options Exercised and Stock Vested

The following table presents, with respect to the Named Executive Officers, certain information about option exercises and restricted stock vested during fiscal 2011.

Options Exercised and Stock Vested Table for Fiscal 2011

	Option Awards			Stock Awards		
Named Executive Officer	Number of Shares Acquired on Exercise	Value Realized on Exercise (a)		Number of Shares Acquired on Vesting	Value Realized on Vesting (a)	
David C. Bupp	1,525,000	$ 5,774,650	(b)	1,000,000	$ 3,576,000	(c),(d)
Mark J. Pykett, V.M.D., Ph.D.	—	—		—	—	
Rodger A. Brown	190,000	488,100	(e)	—	—	
Frederick O. Cope, Ph.D.	—	—		—	—	
Brent L. Larson	120,000	310,300	(f)	—	—	
Thomas H. Tulip, Ph.D.	—	—		20,000	49,980	(g)

(a) Computed using the fair market value of the stock on the date prior to or the date of exercise or vesting, as appropriate, in accordance with our normal practice.

(b) On April 13, 2011, Mr. Bupp exercised options to purchase 1,525,000 shares of common stock at exercise prices ranging from $0.13 to $0.49 per share and a weighted average exercise price of $0.32 per share. After cancelling 637,321 shares of stock to cover the exercise price and related taxes, we issued 887,679 shares of common stock to Mr. Bupp. The market price on the date of exercise was $4.11 per share.

(c) On April 15, 2011, 700,000 shares of Mr. Bupp's restricted stock vested in accordance with the terms of his restricted stock agreements and his separation agreement. The market price of the stock on the vesting date was $4.03 per share.

(d) On August 15, 2011, 300,000 shares of Mr. Bupp's restricted stock vested upon ratification by our stockholders of the amendment to the Company's Amended and Restated 2002 Stock Incentive Plan at the 2011 Annual Meeting of Stockholders, in accordance with the terms of his restricted stock agreement and his separation agreement. The market price on the date prior to vesting was $2.52 per share.

(e) On November 1, 2011, Mr. Brown exercised options to purchase 190,000 shares of common stock at exercise prices ranging from $0.13 to $0.42 per share and a weighted average exercise price of $0.27 per share. After cancelling 80,779 shares of stock to cover the exercise price and related taxes, we issued 109,221 shares of common stock to Mr. Brown. The market price on the date prior to exercise was $2.84 per share.

(f) On November 1, 2011, Mr. Larson exercised options to purchase 120,000 shares of common stock at exercise prices ranging from $0.13 to $0.42 per share and a weighted average exercise price of $0.25 per share. After cancelling 47,287 shares of stock to cover the exercise price and related taxes, we issued 72,713 shares of common stock to Mr. Larson. The market price on the date prior to exercise was $2.84 per share.

(g)

On December 9, 2011, the execution of the license agreement with AstraZeneca caused 20,000 shares of Dr. Tulip's restricted stock to vest in accordance with the terms of his restricted stock agreement. The market price of the stock on the vesting date was $2.50 per share.

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Compensation of Non-Employee Directors

Each non-employee director received an annual cash retainer of $25,000 and earned an additional $2,500 per board meeting attended in person or $500 per telephonic board meeting during the fiscal year ended December 31, 2011. The Chairman of the Company's Board of Directors received an additional annual retainer of $12,500, the Chairman of the Audit Committee received an additional annual retainer of $10,000, the Vice Chairman of the Board of Directors received an additional annual retainer of $5,000, and the Chairman of the CNG Committee received an additional annual retainer of $3,750 for their services in those capacities during 2011. Members of all committees of the Company's Board of Directors earned an additional $1,000 per committee meeting, whether attended in person or telephonically. We also reimbursed non-employee directors for travel expenses for meetings attended during 2011.

Each non-employee director also received 17,000 shares of restricted stock as a part of the Company's annual stock incentive grants, in accordance with the provisions of the Navidea Biopharmaceuticals, Inc. Third Amended and Restated 2002 Stock Incentive Plan. The restricted stock granted will vest on the date of approval by FDA of a Phase 3 clinical program for a RIGS technology product or the approval of marketing authorization for a RIGS technology product by EMA. The aggregate number of equity awards outstanding at February 17, 2012 for each Director is set forth in the footnotes to the beneficial ownership table provided in Part III, Item 12 of this Form 10-K. Directors who are also officers or employees of Neoprobe do not receive any compensation for their services as directors.

The following table sets forth certain information concerning the compensation of non-employee Directors for the fiscal year ended December 31, 2011.

Name	(a) Fees Earned or Paid in Cash	(b),(c) Option Awards	(d),(e) Stock Awards	All Other Compensation	Total Compensation
Carl J. Aschinger, Jr. (f)	$ 40,625	$—	$45,033	$ —	$ 85,658
David C. Bupp (g)	31,250	—	—	—	31,250
David C. Bupp (h)	—	—	—	31,825	31,825
Peter F. Drake, Ph.D. (i)	36,563	—	88,043	—	124,606
Brendan A. Ford	59,250	—	45,033	—	104,283
Owen E. Johnson, M.D. (f)	32,250	—	45,033	—	77,283
Jess Emery Jones, M.D. (i)	32,750		88,043	—	120,793
Fred B. Miller (f)	39,000	—	45,033	—	84,033
Eric K. Rowinsky, M.D.	48,500	—	45,033	—	93,533
Eric K. Rowinsky, M.D. (j)	—	92,398	171,540	98,433	362,371
Gordon A. Troup	55,625	—	45,033	—	100,658

(a) Amount represents fees earned during the fiscal year ended December 31, 2011 (i.e., the year to which the service relates). Quarterly retainers and meeting attendance fees are paid during the quarter following the quarter in which they are earned.

(b) Amount represents the aggregate grant date fair value in accordance with FASB ASC Topic 718. Assumptions made in the valuation of stock option awards are disclosed in Note 1(e) of the Notes to the Consolidated Financial Statements in this Form 10-K.

(c) At December 31, 2011, the non-employee directors held an aggregate of 50,000 options to purchase shares of common stock of the Company. Dr. Rowinsky held 30,000 options and Mr. Troup held 20,000 options.

(d) Amount represents the aggregate grant date fair value in accordance with FASB ASC Topic 718. Assumptions made in the valuation of restricted stock awards are disclosed in Note 1(e) of the Notes to the Consolidated Financial Statements in this Form 10-K.

(e) At December 31, 2011, the non-employee directors held an aggregate of 505,000 shares of unvested restricted stock. Mr. Bupp held 300,000 shares of unvested restricted stock, Messrs. Ford and Troup each held 47,000 shares of unvested restricted stock, Drs. Drake and Jones each held 17,000 shares of unvested restricted stock, and Dr. Rowinsky held 77,000 shares of unvested restricted stock.

(f) Mr. Aschinger, Dr. Johnson, and Mr. Miller retired from our Board of Directors effective August 15, 2011, the date of the 2011 Annual Meeting.

(g) Mr. Bupp retired from his position as the Company's President and Chief Executive Officer and therefore became a non-employee director of the Company effective April 15, 2011.

(h) Following his retirement, Mr. Bupp continued to provide services to the Company under a consulting agreement, earning a total of $31,825 during the year ended December 31, 2011.

(i) Drs. Drake and Jones were appointed to the Company's Board of Directors effective May 23, 2011.

(j) In addition to his service as a Board member, Dr. Rowinsky provided services to the Company under a consulting agreement. During the year ended December 31, 2011, Dr. Rowinsky earned a total of $98,433 in cash consulting

fees, and was issued 60,000 options to purchase shares of common stock of the Company and 60,000 shares of restricted stock, 30,000 shares of which vested on December 9, 2011 upon the Company's execution of the AstraZeneca license agreement.

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Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Equity Compensation Plan Information

The following table sets forth additional information as of December 31, 2011, concerning shares of our common stock that may be issued upon the exercise of options and other rights under our existing equity compensation plans and arrangements, divided between plans approved by our stockholders and plans or arrangements not submitted to our stockholders for approval. The information includes the number of shares covered by, and the weighted average exercise price of, outstanding options and other rights and the number of shares remaining available for future grants excluding the shares to be issued upon exercise of outstanding options, warrants, and other rights.

	(a) Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights	(b) Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights	(c) Number of Securities Remaining Available for Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a))
Equity compensation plans approved by security holders[(1)]	3,315,000	$ 1.02	2,351,177
Equity compensation plans not approved by security holders	—	—	—
Total	3,315,000	$ 1.02	2,351,177

(1) Our stockholders ratified the Third Amended and Restated 2002 Stock Incentive Plan (the Plan) at the 2011 Annual Meeting of Stockholders held on August 15, 2011, which (1) increased the total number of shares available for grant under the Plan to 10,000,000 shares; and (2) extended the expiration date for the Plan from March 7, 2012, to March 7, 2015.

Security Ownership of Principal Stockholders, Directors, Nominees and Executive Officers and Related Stockholder Matters

The following table sets forth, as of February 17, 2012, certain information with respect to the beneficial ownership of shares of our common stock by: (i) each person known to us to be the beneficial owner of more than 5% of our outstanding shares of common stock, (ii) each director or nominee for director of our Company, (iii) each of the Named Executive Officers (see "Executive Compensation – Summary Compensation Table"), and (iv) our directors and executive officers as a group.

Beneficial Owner	**Number of Shares Beneficially Owned (*)**		**Percent of Class (**)**	
Rodger A. Brown	332,554	(a)	(m)	
Frederick O. Cope, Ph.D.	140,358	(b)	(m)	
Peter F. Drake, Ph.D.	10,000	(c)	(m)	
Brendan A. Ford	50,000	(d)	(m)	
Jess Emery Jones, M.D.	—	(e)	(m)	
Brent L. Larson	719,744	(f)	(m)	
Mark J. Pykett, V.M.D., Ph.D.	71,067	(g)	(m)	
Eric K. Rowinsky, M.D.	75,000	(h)	(m)	
Gordon A. Troup	70,000	(i)	(m)	
Thomas H. Tulip, Ph.D.	20,000	(j)	(m)	
All directors and officers as a group (10 persons)	1,488,723	(k)(n)	1.5	%
Platinum Montaur Life Sciences, LLC	4,465,813	(l)	4.7	%

(*) Beneficial ownership is determined in accordance with the rules of the Securities and Exchange Commission which generally attribute beneficial ownership of securities to persons who possess sole or shared voting power and/or investment power with respect to those securities. Unless otherwise indicated, voting and investment power are exercised solely by the person named above or shared with members of such person's household.

(**) Percent of class is calculated on the basis of the number of shares outstanding on February 17, 2012, plus the number of shares the person has the right to acquire within 60 days of February 17, 2012.

(a) This amount includes 223,333 shares issuable upon exercise of options which are exercisable within 60 days, but it does not include 45,000 shares of unvested restricted stock and 126,667 shares issuable upon exercise of options which are not exercisable within 60 days.

(b) This amount includes 130,000 shares issuable upon exercise of options which are exercisable within 60 days and 5,358 shares in Dr. Cope's account in the 401(k) Plan, but it does not include 175,000 shares of unvested restricted stock and 242,000 shares issuable upon exercise of options which are not exercisable within 60 days.

(c) This amount does not include 17,000 shares of unvested restricted stock.

(d) This amount does not include 47,000 shares of unvested restricted stock.

(e) This amount does not include 17,000 shares of unvested restricted stock.

(f)

This amount includes 408,750 shares issuable upon exercise of options which are exercisable within 60 days and 95,869 shares in Mr. Larson's account in the 401(k) Plan, but it does not include 125,000 shares of unvested restricted stock and 184,250 shares issuable upon exercise of options which are not exercisable within 60 days.

(g) This amount includes 66,667 shares issuable upon exercise of options which are exercisable within 60 days and 1,100 shares held in an IRA which is owned by Dr. Pykett, but it does not include 650,000 shares of unvested restricted stock and 383,333 shares issuable upon exercise of options which are not exercisable within 60 days.

(h) This amount includes 30,000 shares issuable upon exercise of options which are exercisable within 60 days, but it does not include 77,000 shares of unvested restricted stock and 30,000 shares issuable upon exercise of options which are not exercisable within 60 days.

(i) This amount includes 20,000 shares issuable upon exercise of options which are exercisable within 60 days, but it does not include 47,000 shares of unvested restricted stock.

(j) This amount does not include 60,000 shares of unvested restricted stock and 273,000 shares issuable upon exercise of options which are not exercisable within 60 days.

(k) This amount includes 878,750 shares issuable upon exercise of options which are exercisable within 60 days, 1,100 shares that are held in an IRA owned by Dr. Pykett, and 101,227 shares held in the 401(k) Plan on behalf of certain officers, but it does not include 1,260,000 shares of unvested restricted stock and 1,239,250 shares issuable upon the exercise of options which are not exercisable within 60 days. The Company itself is the trustee of the Neoprobe 401(k) Plan and may, as such, share investment power over common stock held in such plan. The trustee disclaims any beneficial ownership of shares held by the 401(k) Plan. The 401(k) Plan holds an aggregate total of 644,293 shares of common stock. The 10 persons referenced in this disclosure include each director and named executive officer listed in the table.

(l) Based on information filed on Schedule 13D/A with the Securities and Exchange Commission on April 21, 2011. The number of shares beneficially owned by Platinum-Montaur Life Sciences, LLC (Montaur), 152 W. 57th Street, 54th Floor, New York, NY 10019, does not include 29,701,410 shares of common stock issuable upon conversion of 917 shares of Series B Convertible Preferred Stock, 6,000,000 shares of common stock issuable upon exercise of a Series W Warrant issued to Montaur on December 26, 2007, as amended (the Series W Warrant), 8,333,333 shares of common stock issuable upon exercise of a Series X Warrant issued to Montaur on April 16, 2008 (the Series X Warrant), and 2,400,000 shares of common stock issuable upon exercise of a Series AA Warrant issued to Montaur on July 24, 2009 (the Series AA Warrant). The Certificates of Designation of the Preferred Stock, the Series W Warrant, the Series X Warrant and the Series AA Warrant each provide that the holder of shares of the Preferred Stock, the Series W Warrant, the Series X Warrant and the Series AA Warrant, respectively, may not convert any of the preferred stock or exercise any of the warrants to the extent that such conversion or exercise would result in the holder and its affiliates together beneficially owning more than 9.99% of the outstanding shares of common stock, except on 61 days' prior written notice to Navidea that the holder waives such limitation.

(m) Less than one percent.

(n) The address of all directors and executive officers is c/o Navidea Biopharmaceuticals, Inc., 425 Metro Place North, Suite 450, Dublin, Ohio 43017-1367.

Item 13. Certain Relationships and Related Transactions, and Director Independence

Certain Relationships and Related Transactions

We adhere to our Code of Business Conduct and Ethics, which states that no director, officer or employee of Navidea should have any personal interest that is incompatible with the loyalty and responsibility owed to our Company. We do not currently have a written policy regarding related party transactions. When considering whether to enter into a related party transaction, the Board considers a variety of factors including, but not limited to, the nature and type of the proposed transaction, the potential value of the proposed transaction, the impact on the actual or perceived independence of the related party and the potential value to the Company of entering into such a transaction. All proposed transactions with a potential value of greater than $120,000 are approved by the Board.

In July 2007, David C. Bupp, our then-President and CEO, and certain members of his family (the Bupp Investors) purchased a $1.0 million convertible note (the Bupp Note) and warrants. The Bupp Note bore interest at 10% per annum, had an original term of one year and was repayable in whole or in part with no penalty. The note was convertible, at the option of the Bupp Investors, into shares of our common stock at a price of $0.31 per share. As part of this transaction, we issued the Bupp Investors Series V warrants to purchase 500,000 shares of our common stock at an exercise price of $0.31 per share, expiring in July 2012.

In December 2007, we extended the term of the $1.0 million Bupp Note to December 31, 2011. In consideration for the Bupp Investors' agreement to extend the term of the Bupp Note, we agreed to provide security for the obligations

evidenced by the amended Bupp Note (the Amended Bupp Note), under the terms of a Security Agreement, dated December 26, 2007, by and between the Company and the Bupp Investors. As further consideration for extending the term of the Bupp Note, we issued the Bupp Investors additional Series V warrants to purchase 500,000 shares of our common stock at an exercise price of $0.32 per share, expiring in December 2012.

In June 2010, we entered into a Securities Exchange Agreement with the Bupp Investors, pursuant to which the Bupp Investors exchanged the Amended Bupp Note for 1,000 shares of Series C Convertible Preferred Stock (the Series C Preferred Stock), convertible into 3,226,000 shares of common stock. The Series C Preferred Stock has a 10% dividend rate, payable quarterly, and participates equally with our common stock in liquidation proceeds based upon the number of common shares into which the Series C Preferred Stock is then convertible. As a result of this exchange transaction, all security interests in the Company’s assets held by the Bupp Investors were extinguished.

During 2011, Mr. Bupp and certain members of his family exercised 810,000 Series V warrants in exchange for issuance of 810,000 shares of our common stock, resulting in gross proceeds of $255,600.

In August 2010, we entered into a Consulting Agreement with Eric K. Rowinsky, M.D. for services related to the development and regulatory strategies regarding Lymphoseek and RIGS, as well as business development assessments and transactions. Dr. Rowinsky's Consulting Agreement was renewed in August 2011. During 2011, we paid Dr. Rowinsky a total of $98,433 in cash consulting fees, and issued 60,000 options to purchase shares of common stock of the Company and 60,000 shares of restricted stock, 30,000 shares of which vested on December 9, 2011 upon the Company's execution of the AstraZeneca license agreement.

Director Independence

Our Board of Directors has adopted the definition of "independence" as described under the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) Section 301, Rule 10A-3 under the Securities Exchange Act of 1934 (the Exchange Act) and Section 803A of the NYSE Amex Company Guide. Our Board of Directors has determined that Messrs. Ford and Troup, and Drs. Drake and Jones, meet the independence requirements. Mr. Aschinger, Dr. Johnson, and Mr. Miller met the independence requirements prior to their retirement effective August 15, 2011.

Item 14. Principal Accountant Fees and Services

Audit Fees.). The aggregate fees billed and expected to be billed for professional services rendered by BDO USA, LLP for the audit of the Company's annual consolidated financial statements for the 2011 fiscal year, the audit of the Company's internal control over financial reporting as of December 31, 2011, the reviews of the financial statements included in the Company's Quarterly Reports on Form 10-Q for the 2011 fiscal year, consents related to the Company's registration statements filed during the 2011 fiscal year, and consulting services related to the Company's sale of the GDS Business during the 2011 fiscal year were $256,617 (including direct engagement expenses). The aggregate fees billed and expected to be billed for professional services rendered by BDO USA, LLP for the audit of the Company's annual consolidated financial statements for the 2010 fiscal year, the audit of the Company's internal control over financial reporting as of December 31, 2010, the reviews of the financial statements included in the Company's Quarterly Reports on Form 10-Q for the 2010 fiscal year, consents related to the Company's registration statements filed during the 2010 fiscal year, and consulting services related to the Company's modification of certain debt and equity instruments during the 2010 fiscal year were $267,171 (including direct engagement expenses).

Audit-Related Fees. No fees were billed by BDO USA, LLP for audit-related services for the 2011 or 2010 fiscal years.

Tax Fees. The aggregate fees billed and expected to be billed for tax-related services rendered by BDO USA, LLP for the IRC Section 382 study and the review of the Company's tax returns for the 2010 tax year during the 2011 fiscal year were $29,285 (including direct engagement expenses). The aggregate fees billed and expected to be billed for

tax-related services rendered by BDO USA, LLP for consulting services related to the Section 48D tax credit and the review of the Company's tax returns for the 2009 tax year during the 2010 fiscal year were $23,410 (including direct engagement expenses).

All Other Fees. No fees were billed by BDO USA, LLP for services other than the audit, audit-related and tax services for the 2011 or 2010 fiscal years.

Pre-Approval Policy. The Audit Committee is required to pre-approve all auditing services and permitted non-audit services (including the fees and terms thereof) to be performed for the Company by its independent auditor or other registered public accounting firm, subject to the *de minimis* exceptions for permitted non-audit services described in Section 10A(i)(1)(B) of the Securities Exchange Act of 1934 that are approved by the Audit Committee prior to completion of the audit. The Audit Committee, through the function of the Chairman, has given general pre-approval for 100% of specified audit, audit-related, tax and other services.

PART IV

Item 15. Exhibits, Financial Statement Schedules

Exhibit Number	Exhibit Description
3.1	Amended and Restated Certificate of Incorporation of Navidea Biopharmaceuticals, Inc., as corrected February 18, 1994, and amended June 27, 1994, July 25, 1995, June 3, 1996, March 17, 1999, May 9, 2000, June 13, 2003, July 29, 2004, June 22, 2005, November 20, 2006, December 26, 2007, April 30, 2009, July 27, 2009, August 2, 2010, and January 5, 2012).*
3.2	Certificate of Ownership Merging Neoprobe Name Change, Inc. into Neoprobe Corporation, effective January 5, 2012, as filed with the Delaware Secretary of State (filed as Exhibit 3.1 to the Company's Current Report on Form 8-K filed December 21, 2011, and incorporated herein by reference).
3.3	Amended and Restated By-Laws dated July 21, 1993, as amended July 18, 1995, May 30, 1996 and July 26, 2007 (filed as Exhibit 3.2 to the Company's Current Report on Form 8-K filed August 3, 2007, and incorporated herein by reference).
4.1	Certificate of Designations, Voting Powers, Preferences, Limitations, Restrictions, and Relative Rights of Series B Cumulative Convertible Preferred Stock (incorporated by reference to Exhibit 4.1 to the Company's Current Report on Form 8-K filed June 28, 2010).
4.2	Certificate of Designations, Voting Powers, Preferences, Limitations, Restrictions, and Relative Rights of Series C 10% Cumulative Convertible Preferred Stock (incorporated by reference to Exhibit 4.2 to the Company's Current Report on Form 8-K filed June 28, 2010).
10.1	Navidea Biopharmaceuticals, Inc. Third Amended and Restated 2002 Stock Incentive Plan (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed August 15, 2011).
10.2	Form of Stock Option Agreement under the Navidea Biopharmaceuticals, Inc. Third Amended and Restated 2002 Stock Incentive Plan (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed December 21, 2006).
10.3	Form of Restricted Stock Award and Agreement under the Third Amended and Restated 2002 Stock Incentive Plan (incorporated by reference to Exhibit 10.3 to the Company's Current Report on Form 8-K filed January 9, 2008).
10.4	Form of Employment Agreement between the Company and each of Drs. Mark J. Pykett, Frederick O. Cope and Thomas H. Tulip, and Messrs. Brent L. Larson and Rodger A Brown. This agreement is one of five substantially identical employment agreements and is accompanied by a schedule which identifies material details in which each individual agreement differs from the form filed herewith (incorporated by reference to the Company's Current Report on Form 8-K filed December 27, 2010).

10.5	Schedule identifying material differences between the employment agreements incorporated by reference as Exhibit 10.4 to this Annual Report on Form 10-K.*

10.6	Technology Transfer Agreement, dated July 29, 1992, between the Company and The Dow Chemical Corporation (portions of this Exhibit have been omitted pursuant to a request for confidential treatment and have been filed separately with the Commission) (incorporated by reference to Exhibit 10.10 to the Company's Form S-1 filed October 15, 1992).
10.7	Cooperative Research and Development Agreement between the Company and the National Cancer Institute (incorporated by reference to Exhibit 10.3.31 to the Company's September 30, 1995, Form 10–QSB).
10.8	License, dated May 1, 1996, between the Company and The Dow Chemical Company (incorporated by reference to Exhibit 10.3.45 to the Company's June 30, 1996, Form 10–QSB).
10.9	License Agreement, dated May 1, 1996, between the Company and The Dow Chemical Company (portions of this Exhibit have been omitted pursuant to a request for confidential treatment and have been filed separately with the Commission) (incorporated by reference to Exhibit 10.3.46 to the Company's June 30, 1996, Form 10–QSB).
10.10	License Agreement, dated January 30, 2002, between the Company and the Regents of the University of California, San Diego, as amended on May 27, 2003 and February 1, 2006 (portions of this Exhibit have been omitted pursuant to a request for confidential treatment and have been filed separately with the Commission) (incorporated by reference to Exhibit 10.11 to the Company's Annual Report on Form 10-KSB filed March 31, 2006).
10.11	Evaluation License Agreement, dated March 31, 2005, between the Company and the Regents of the University of California, San Diego (portions of this Exhibit have been omitted pursuant to a request for confidential treatment and have been filed separately with the Commission) (incorporated by reference to Exhibit 10.12 to the Company's Annual Report on Form 10-KSB filed March 31, 2006).
10.12	Product Supply Agreement between the Company and TriVirix International, Inc., dated February 5, 2004 (portions of this Exhibit have been omitted pursuant to a request for confidential treatment and have been filed separately with the Commission) (incorporated by reference to Exhibit 10.17 to the Company's December 31, 2004 Form 10-KSB).
10.13	Supply and Distribution Agreement, dated November 15, 2007, by and between the Company and Cardinal Health 414, LLC (portions of this Exhibit have been omitted pursuant to a request for confidential treatment and have been filed separately with the Commission) (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed November 21, 2007).
10.14	Manufacture and Supply Agreement, dated November 30, 2009, between the Company and Reliable Biopharmaceutical Corporation (portions of this Exhibit have been omitted pursuant to a request for confidential treatment and have been filed separately with the Commission) (incorporated by reference to Exhibit 10.1 to the Company's June 30, 2010 Form 10-Q).
10.15	Series V Warrant to Purchase Common Stock issued to David C. Bupp, Cynthia B. Gochoco and Walter H. Bupp, as joint tenants with right of survivorship (incorporated by reference to Exhibit 10.3 to the Company's Current Report on Form 8-K filed July 9, 2007).

10.16	Registration Rights Agreement, dated July 3, 2007, by and among the Company and David C. Bupp, Cynthia B. Gochoco and Walter H. Bupp, as joint tenants with right of survivorship (incorporated by reference to Exhibit 10.4 to the Company's Current Report on Form 8-K filed July 9, 2007).
10.17	Securities Purchase Agreement, dated as of December 26, 2007, by and between the Company and Platinum-Montaur Life Sciences, LLC (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed January 2, 2008).
10.18	Amendment and Waiver for Securities Purchase Agreement, dated April 16, 2008, between the Company and Platinum-Montaur Life Sciences, LLC (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed April 18, 2008).
10.19	Agreement Modifying the Interest and Dividend Payment Dates of the Company's Series A and B Promissory Notes and Series A Preferred Stock, and Exercise and Conversion Price Adjustment Provisions of the Company's Series X and Y Warrants and Series A Preferred Stock, dated March 31, 2009, by and between the Company and Platinum-Montaur Life Sciences, LLC (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed April 6, 2009).
10.20	Securities Amendment and Exchange Agreement, dated July 24, 2009, by and between the Company and Platinum-Montaur Life Sciences, LLC (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed July 29, 2009).
10.21	Amended and Restated Series W Warrant to Purchase Shares of Common Stock of the Company issued to Platinum-Montaur Life Sciences, LLC (incorporated by reference to Exhibit 10.4 to the Company's Current Report on Form 8-K filed July 29, 2009).
10.22	Amended and Restated Series X Warrant to Purchase Shares of Common Stock of the Company issued to Platinum-Montaur Life Sciences, LLC (incorporated by reference to Exhibit 10.5 to the Company's Current Report on Form 8-K filed July 29, 2009).
10.23	Series AA Warrant to Purchase Shares of Common Stock of the Company issued to Platinum-Montaur Life Sciences, LLC (incorporated by reference to Exhibit 10.7 to the Company's Current Report on Form 8-K filed July 29, 2009).
10.24	Registration Rights Agreement, dated December 26, 2007, between the Company and Platinum-Montaur Life Sciences, LLC (incorporated by reference to Exhibit 10.7 to the Company's Current Report on Form 8-K filed January 2, 2008).
10.25	Second Amendment to Registration Rights Agreement, dated April 16, 2008, between the Company and Platinum-Montaur Life Sciences, LLC (incorporated by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K filed April 18, 2008).
10.26	Third Amendment to Registration Rights Agreement, dated July 10, 2008, between the Company and Platinum-Montaur Life Sciences, LLC (incorporated by reference to Exhibit 10.55 to pre-effective amendment No. 2 to the Company's Registration Statement on Form S-1, filed July 24, 2008, Registration file No. 333-150650).
10.27	

	Fourth Amendment to Registration Rights Agreement, dated December 5, 2008, between the Company and Platinum-Montaur Life Sciences, LLC (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed December 9, 2008).
10.28	Fifth Amendment to Registration Rights Agreement, dated December 21, 2009, between the Company and Platinum-Montaur Life Sciences, LLC (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed December 22, 2009).

10.29	Securities Exchange Agreement, dated June 22, 2010, by and between the Company and Platinum-Montaur Life Sciences, LLC (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed June 28, 2010).
10.30	Securities Exchange Agreement, dated June 22, 2010, by and among the Company, and David C. Bupp and Cynthia B. Gochoco, both individually and as co-executors of the Estate of Walter H. Bupp (incorporated by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K filed June 28, 2010).
10.31	Letter Agreement, dated November 7, 2010, by and between the Company and Rodman & Renshaw, LLC (incorporated by reference to Exhibit 1.1 to the Company's Current Report on Form 8-K filed November 12, 2010).
10.32	Securities Purchase Agreement, dated November 7, 2010, by and among the Company and each purchaser identified on the signature pages thereto (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed November 12, 2010).
10.33	Form of Series CC Common Stock Purchase Warrant (incorporated by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K filed November 12, 2010).
10.34	Form of Series DD Common Stock Purchase Warrant (incorporated by reference to Exhibit 10.3 to the Company's Current Report on Form 8-K filed November 12, 2010).
10.35	Form of Series EE Common Stock Purchase Warrant (incorporated by reference to Exhibit 10.4 to the Company's Current Report on Form 8-K filed November 12, 2010).
10.36	Navidea Biopharmaceuticals, Inc. 2011 Cash Bonus Plan (incorporated by reference to the Company's Current Report on Form 8-K filed December 27, 2010).
10.37	Separation Agreement and Release, dated March 30, 2011, by and between the Company and David C. Bupp (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed April 1, 2011).
10.38	Consulting Agreement, dated March 30, 2011, by and between the Company and David C. Bupp (incorporated by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K filed April 1, 2011).
10.39	Employment Agreement, effective April 15, 2011, by and between the Company and Mark J. Pykett (incorporated by reference to Exhibit 10.3 to the Company's Current Report on Form 8-K filed April 1, 2011).
10.40	Relocation Agreement, dated March 30, 2011, by and between the Company and Mark J. Pykett (incorporated by reference to Exhibit 10.4 to the Company's Current Report on Form 8-K filed April 1, 2011).
10.41	Settlement Agreement, dated April 18, 2011, by and among Platinum-Montaur Life Sciences, LLC, Platinum Partners Value Arbitrage Fund, L.P. and the Company (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed April 18, 2011).
10.42	Asset Purchase Agreement, dated May 24, 2011, by and between Devicor Medical Products, Inc. and the Company (portions of this Exhibit have been omitted pursuant to a request for confidential treatment and have been filed separately with the SEC) (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K/A filed July 19, 2011).

10.43	Employment Agreement, dated June 1 2011, between the Company and Thomas H. Tulip, Ph.D (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed June 6, 2011).
10.44	Consulting Services Agreement, dated August 3, 2011, by and between the Company and Eric K. Rowinsky, M.D. (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed August 4, 2011).
10.45	License Agreement, dated December 9, 2011, by and between AstraZeneca AB and the Company (portions of this Exhibit have been omitted pursuant to a request for confidential treatment and have been filed separately with the United States Securities and Exchange Commission) (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed December 15, 2011).
10.46	Loan and Security Agreement, dated December 29, 2011, by and between the Company and Hercules Technology II, L.P. (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed January 5, 2012).
10.47	Series GG Warrant to Purchase Common Stock of the Company issued to Hercules Technology II, L.P. on December 29, 2011 (incorporated by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K filed January 5, 2012).
21.1	Subsidiaries of the registrant.*
23.1	Consent of BDO USA, LLP.*
24.1	Power of Attorney.*
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.*
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 of Periodic Financial Reports pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350.*
32.2	Certification of Chief Financial Officer of Periodic Financial Reports pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350.*

* Filed herewith.

SIGNATURES

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

Dated: March 6, 2012

NAVIDEA BIOPHARMACEUTICALS, INC.
(the Company)

By: /s/ Mark J. Pykett
Mark J. Pykett
President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ Mark J. Pykett Mark J. Pykett	Director, President and Chief Executive Officer (principal executive officer)	February 16, 2012
/s/ Brent L. Larson* Brent L. Larson	Senior Vice President and Chief Financial Officer (principal financial officer)	February 16, 2012
/s/ Gordon A. Troup* Gordon A. Troup	Chairman, Director	February 16, 2012
/s/ Peter F. Drake* Peter F. Drake	Director	February 16, 2012
/s/ Brendan A. Ford* Brendan A. Ford	Director	February 16, 2012
/s/ Jess Emery Jones* Jess Emery Jones	Director	February 16, 2012
/s/ Eric K. Rowinsky* Eric K. Rowinsky	Director	February 16, 2012

*By: /s/ Mark J. Pykett
Mark J. Pykett, Attorney-in-fact

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

NAVIDEA BIOPHARMACEUTICALS, INC.

(formerly Neoprobe Corporation)

FORM 10-K ANNUAL REPORT

As of December 31, 2011 and 2010

and for Each of the

Three Years in the Period Ended

December 31, 2011

FINANCIAL STATEMENTS

NAVIDEA BIOPHARMACEUTICALS, INC. and SUBSIDIARIES

(formerly Neoprobe Corporation)

Index to Financial Statements

Consolidated Financial Statements of Navidea Biopharmaceuticals, Inc.

Report of Independent Registered Public Accounting Firm

Board of Directors

Navidea Biopharmaceuticals, Inc.

Dublin, Ohio

We have audited the accompanying consolidated balance sheets of Navidea Biopharmaceuticals, Inc. (formerly Neoprobe Corporation) as of December 31, 2011 and 2010 and the related consolidated statements of operations and comprehensive income (loss), stockholders' equity (deficit) and cash flows for each of the three years in the period ended December 31, 2011. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Navidea Biopharmaceuticals, Inc. at December 31, 2011 and 2010, and the results of its operations and cash flows for each of the three years in the period ended December 31, 2011, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Navidea Biopharmaceuticals, Inc.'s internal control over financial reporting as of December 31, 2011, based on criteria established in *Internal Control−Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated March 6, 2012 expressed an unqualified opinion thereon.

/s/ BDO USA, LLP

Chicago, Illinois

March 6, 2012

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Navidea Biopharmaceuticals, Inc. and Subsidiaries (formerly Neoprobe Corporation)

Consolidated Balance Sheets

	December 31, 2011	December 31, 2010
ASSETS		
Current assets:		
Cash	$ 28,644,004	$ 6,420,506
Accounts receivable, net	15,794	137,958
Inventory	821,549	632,000
Prepaid expenses and other	554,544	257,899
Assets associated with discontinued operations, current	10,630	2,784,640
Total current assets	30,046,521	10,233,003
Property and equipment	1,441,229	1,366,105
Less accumulated depreciation and amortization	977,960	960,726
	463,269	405,379
Patents and trademarks	106,592	63,643
Less accumulated amortization	21,171	21,171
	85,421	42,472
Other assets	598,709	7,421
Assets associated with discontinued operations	—	174,463
Total assets	$ 31,193,920	$ 10,862,738

Continued

Navidea Biopharmaceuticals, Inc. and Subsidiaries (formerly Neoprobe Corporation)

Consolidated Balance Sheets, continued

	December 31, 2011	December 31, 2010
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$681,754	$1,357,796
Accrued liabilities and other	2,087,722	1,014,130
Note payable to finance company	—	62,411
Derivative liabilities, current	568,930	405,524
Liabilities associated with discontinued operations, current	10,064	1,104,578
Total current liabilities	3,348,470	3,944,439
Note payable to investor, net of discount of $543,612	6,456,388	—
Derivative liabilities	—	2,077,799
Liabilities associated with discontinued operations	—	672,924
Other liabilities	257,315	35,831
Total liabilities	10,062,173	6,730,993
Commitments and contingencies		
Stockholders' equity:		
Preferred stock; $.001 par value; 5,000,000 shares authorized; 9,083 Series B shares and 1,000 Series C shares issued and outstanding at December 31, 2011, and 10,000 Series B shares and 1,000 Series C shares issued and outstanding at December 31, 2010	10	11
Common stock; $.001 par value; 200,000,000 shares authorized; 95,398,961 and 86,319,913 shares issued and outstanding at December 31, 2011 and 2010, respectively	95,399	86,320
Additional paid-in capital	266,393,645	254,915,713
Accumulated deficit	(245,357,307)	(250,870,299)
Total stockholders' equity	21,131,747	4,131,745
Total liabilities and stockholders' equity	$31,193,920	$10,862,738

See accompanying notes to consolidated financial statements.

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Navidea Biopharmaceuticals, Inc. and Subsidiaries (formerly Neoprobe Corporation)

Consolidated Statements of Operations and Comprehensive Income (Loss)

	Years Ended December 31,		
	2011	2010	2009
Grant revenue	$597,729	$617,392	$—
Operating expenses:			
Research and development	15,154,365	8,941,046	4,379,614
Selling, general and administrative	9,547,779	4,353,136	3,028,500
Total operating expenses	24,702,144	13,294,182	7,408,114
Loss from operations	(24,104,415)	(12,676,790)	(7,408,114)
Other income (expense):			
Interest income	25,755	8,804	18,749
Interest expense	(13,330)	(554,988)	(1,533,047)
Change in derivative liabilities	(952,375)	(1,336,234)	(18,132,274)
Loss on extinguishment of debt	—	(41,717,380)	(16,240,592)
Other	(3,211)	32,594	(3,422)
Total other expense, net	(943,161)	(43,567,204)	(35,890,586)
Loss before income taxes	(25,047,576)	(56,243,994)	(43,298,700)
Benefit from income taxes	7,880,143	2,134,903	1,255,613
Loss from continuing operations	(17,167,433)	(54,109,091)	(42,043,087)
Discontinued operations, net of tax effect:			
Gain on sale	19,450,891	—	—
Impairment loss	—	—	(1,131,123)
Income from operations	3,329,534	4,144,223	3,568,490
Net income (loss)	5,612,992	(49,964,868)	(39,605,720)
Preferred stock dividends	(100,000)	(8,206,745)	(240,000)
Income (loss) attributable to common stockholders	$5,512,992	$(58,171,613)	$(39,845,720)
Income (loss) per common share (basic and diluted):			
Continuing operations	$(0.17)	$(0.77)	$(0.57)
Discontinued operations	$0.23	$0.05	$0.03
Attributable to common stockholders	$0.06	$(0.72)	$(0.54)

Weighted average shares outstanding:			
Basic and diluted	90,509,326	80,726,498	73,771,871
Net income (loss)	$5,612,992	$(49,964,868)	$(39,605,720)
Unrealized loss on available-for-sale securities	—	—	(1,383)
Comprehensive income (loss)	5,612,992	(49,964,868)	(39,607,103)
Preferred stock dividends	(100,000)	(8,206,745)	(240,000)
Comprehensive income (loss) attributable to common stockholders	$5,512,992	$(58,171,613)	$(39,847,103)

See accompanying notes to consolidated financial statements.

Navidea Biopharmaceuticals, Inc. and Subsidiaries (formerly Neoprobe Corporation)

Consolidated Statements of Stockholders' Equity (Deficit)

	Preferred Stock		Common Stock		Additional Paid-In	Accumulated	Accumulated Other Comprehensive	
	Shares	Amount	Shares	Amount	Capital	Deficit	Income (Loss)	Total
Balance, December 31, 2008	—	$—	70,862,641	$70,863	$145,742,044	$(148,840,015)	$1,383	$(3,025,725)
Effect of adopting new provisions of FASB ASC Topic 815	—	—	—	—	(8,948,089)	(4,012,951)	—	(12,961,040)
Issued restricted stock to employees and directors	—	—	1,260,000	1,260	—	—	—	1,260
Cancelled restricted stock	—	—	(9,000)	(9)	9	—	—	—
Issued stock to 401(k) plan	—	—	80,883	81	33,392	—	—	33,473
Issued stock upon exercise of warrants	—	—	6,948,507	6,949	6,534,985	—	—	6,541,934
Issued stock upon exercise of stock options	—	—	400,441	400	124,216	—	—	124,616
Issued stock in payment of interest on convertible debt and dividends on convertible preferred stock	—	—	1,393,239	1,393	1,029,940	—	—	1,031,333
Paid preferred stock issuance costs	—	—	—	—	(6,323)	—	—	(6,323)
Paid common stock issuance costs	—	—	—	—	(207,000)	—	—	(207,000)
	—	—	—	—	37,999,312	—	—	37,999,312

Effect of change in terms of notes payable, preferred stock and warrants								
Stock compensation expense	—	—	—	—	445,411	—	—	445,411
Preferred stock dividends	—	—	—	—	—	(240,000)	—	(240,000)
Net loss	—	—	—	—	—	(39,605,720)	—	(39,605,720)
Unrealized loss on available-for-sale securities	—	—	—	—	—	—	(1,383)	(1,383)
Balance, December 31, 2009	—	—	80,936,711	80,937	182,747,897	(192,698,686)	—	(9,869,852)
Issued stock in payment of interest on convertible debt and dividends on convertible preferred stock	—	—	347,832	348	476,319	—	—	476,667
Issued stock upon exercise of options, net of costs	—	—	350,156	350	(64,055)	—	—	(63,705)
Issued stock in connection with stock purchase agreement, net of costs	—	—	660,541	661	776,797	—	—	777,458
Issued stock to 401(k) plan	—	—	53,499	53	40,570	—	—	40,623
Issued Series B and Series C convertible preferred stock, net of costs	11,000	11	—	—	64,636,810	—	—	64,636,821
Cancelled restricted stock	—	—	(4,500)	(5)	5	—	—	—
Issued restricted stock	—	—	660,000	660	—	—	—	660
Issued warrants in connection with consulting agreement	—	—	—	—	279,367	—	—	279,367

Issued stock upon exercise of warrants and other	—	—	157,778	158	316,660	—	—	316,818
Issued common stock and warrants in connection with direct offering, net of costs	—	—	3,157,896	3,158	4,306,793	—	—	4,309,951
Effect of change in terms of warrants	—	—	—	—	800,878	—	—	800,878
Stock compensation expense	—	—	—	—	597,672	—	—	597,672
Preferred stock dividends, including deemed dividends	—	—	—	—	—	(8,206,745)	—	(8,206,745)
Net loss	—	—	—	—	—	(49,964,868)	—	(49,964,868)
Balance, December 31, 2010	11,000	11	86,319,913	86,320	254,915,713	(250,870,299)	—	4,131,745

Continued

Navidea Biopharmaceuticals, Inc. and Subsidiaries (formerly Neoprobe Corporation)

Consolidated Statements of Stockholders' Equity (Deficit), continued

	Preferred Stock		Common Stock		Additional Paid-In	Accumulated	Accumulated Other Comprehensive	
	Shares	Amount	Shares	Amount	Capital	Deficit	Income (Loss)	Total
Balance, December 31, 2010	11,000	11	86,319,913	86,320	254,915,713	(250,870,299)	—	4,131,745
Issued restricted stock	—	—	872,000	872	—	—	—	872
Cancelled restricted stock	—	—	(686,000)	(686)	90	—	—	(596)
Issued stock to 401(k) plan	—	—	35,233	35	61,936	—	—	61,971
Issued stock upon exercise of warrants, net	—	—	4,026,552	4,027	8,323,163	—	—	8,327,190
Issued stock upon exercise of stock options, net of related income tax withholdings	—	—	1,832,673	1,832	(2,500,055)	—	—	(2,498,223)
Effect of change in terms of warrants	—	—	—	—	1,978,818	—	—	1,978,818
Conversion of Series B preferred stock to common stock	(917)	(1)	2,998,590	2,999	(2,998)	—	—	—
Effect of beneficial conversion feature of promissory note	—	—	—	—	24,888	—	—	24,888
Stock compensation expense	—	—	—	—	3,592,090	—	—	3,592,090
Preferred stock dividends	—	—	—	—	—	(100,000)	—	(100,000)
Net income	—	—	—	—	—	5,612,992	—	5,612,992

Balance, December 31, 2011	10,083	$ 10	95,398,961	$95,399	$266,393,645	$(245,357,307)	$ —	$21,131,747

See accompanying notes to consolidated financial statements.

Navidea Biopharmaceuticals, Inc. and Subsidiaries (formerly Neoprobe Corporation)

Consolidated Statements of Cash Flows

	Years Ended December 31,		
	2011	2010	2009
Cash flows from operating activities:			
Net income (loss)	$5,612,992	$(49,964,868)	$(39,605,720)
Adjustments to reconcile net income (loss) to net cash used in operating activities:			
Depreciation and amortization of equipment	175,296	215,462	202,703
Amortization of intangible assets	1,248	7,998	131,046
Loss on disposal and abandonment of assets	18,645	7,476	18,794
Amortization of debt discount and debt offering costs	3,805	16,109	428,060
Issuance of common stock in payment of interest and dividends	—	476,667	791,333
Stock compensation expense	3,592,090	597,672	445,411
Change in derivative liabilities	952,375	1,336,234	18,132,274
Loss on extinguishment of debt	—	41,717,380	16,240,592
Issuance of warrants in connection with consulting agreement	—	279,367	—
Gain on sale of GDS Business	(26,173,805)	—	—
Impairment loss on Cardiosonix	—	—	1,713,822
Other	61,971	40,623	33,473
Change in operating assets and liabilities:			
Accounts receivable	(219,021)	(707,914)	296,813
Inventory	(53,289)	(381,382)	(653,043)
Prepaid expenses and other assets	(40,204)	39,232	105,262
Accounts payable	(538,666)	759,411	38,146
Accrued liabilities and other liabilities	487,055	157,899	121,277
Deferred revenue	109,503	232,866	77,704
Net cash used in operating activities	(16,010,005)	(5,169,768)	(1,482,053)
Cash flows from investing activities:			
Maturities of available-for-sale securities	—	—	494,000
Purchases of equipment	(183,830)	(366,629)	(96,331)
Proceeds from sales of equipment	1,000	—	251
Proceeds from sale of GDS Business, net	30,159,527	—	—
Payment of transaction costs to sell GDS Business	(2,765,932)	—	—
Patent and trademark costs	(52,504)	(32,111)	(71,344)
Net cash provided by (used in) investing activities	27,158,261	(398,740)	326,576
Cash flows from financing activities:			
Proceeds from issuance of common stock	7,198,373	7,092,163	3,641,010
Payment of tax withholdings related to stock-based compensation	(2,762,710)	(133,153)	(24,134)
Payment of stock issuance costs	—	(478,111)	(219,867)
Payment of preferred stock dividends	(100,000)	(111,389)	—
Proceeds from notes payable	7,000,000	—	—

Payment of debt issuance costs	(189,390)	—	(20,183)
Payment of notes payable	(62,411)	(8,710)	(137,857)
Payments under capital leases	(8,620)	(11,628)	(9,487)
Net cash provided by financing activities	11,075,242	6,349,172	3,229,482
Net increase in cash	22,223,498	780,664	2,074,005
Cash, beginning of year	6,420,506	5,639,842	3,565,837
Cash, end of year	$28,644,004	$6,420,506	$5,639,842

See accompanying notes to consolidated financial statements.

Notes to the Consolidated Financial Statements

1. Organization and Summary of Significant Accounting Policies

a. **Organization and Nature of Operations:** Navidea Biopharmaceuticals, Inc. (formerly Neoprobe Corporation; Navidea, the Company, or we), a Delaware corporation, is a biopharmaceutical company focused on the development and commercialization of precision diagnostics and radiopharmaceutical agents. We are currently developing three radiopharmaceutical agent platforms. The first, Lymphoseek®, is intended to be used in determining the spread of certain solid tumor cancers into the lymphatic system. The second, AZD4694, is intended to be used in the imaging and evaluation of patients with signs or symptoms of cognitive impairment such as Alzheimer's disease (AD). The third, RIGScan™, is intended to be used to help surgeons locate cancerous or disease-involved tissue during colorectal cancer surgeries. All of these drug products are still in development and must be cleared for marketing by the appropriate regulatory bodies before they can be sold in any markets.

Prior to August 2011, we also manufactured a line of gamma radiation detection equipment used in the application of sentinel lymph node biopsy (SLNB). From July 2010 through August 2011, our gamma detection device products were marketed throughout most of the world through a distribution arrangement with Devicor Medical Products, Inc. (Devicor). Prior to July 2010, our gamma detection device products were marketed through a distribution arrangement with Ethicon Endo-Surgery, Inc. (EES), a Johnson & Johnson company. In July 2010, Devicor acquired EES' breast biopsy business, including an assignment of the distribution agreement with the Company. As disclosed below, we sold our gamma detection device line of business (the GDS Business) to Devicor in August 2011. Prior to the disposal of the GDS Business, 96%, 96%, and 92% of net sales were made to Devicor or EES for the years ended December 31, 2011, 2010 and 2009, respectively.

In January 2005 we formed a new corporation, Cira Biosciences, Inc. (Cira Bio), to explore the development of patient-specific cellular therapies that have shown positive patient responses in a variety of clinical settings. Cira Bio is combining our activated cellular therapy (ACT) technology for patient-specific oncology treatment with similar technology licensed from Cira LLC, a privately held company, for treating viral and autoimmune diseases. Navidea owns approximately 90% of the outstanding shares of Cira Bio with the remaining shares being held by the principals of Cira LLC.

In July 2011, we established a European business unit, Navidea Biopharmaceuticals Limited, to address international development and commercialization needs for our technologies, including Lymphoseek. Navidea owns 100% of the outstanding shares of Navidea Biopharmaceuticals Limited.

b. **Principles of Consolidation:** Our consolidated financial statements include the accounts of Navidea, our wholly-owned subsidiary, Cardiosonix, and our majority-owned subsidiary, Cira Bio. All significant inter-company accounts were eliminated in consolidation.

In May 2011, the Company's Board of Directors approved the sale (the Asset Sale) of the GDS Business to Devicor and the Company executed an Asset Purchase Agreement (APA) with Devicor dated May 24, 2011. Our stockholders approved the Asset Sale at our Annual Meeting of Stockholders on August 15, 2011, and the Asset Sale closed on August 17, 2011 consistent with the terms of the APA. Under the terms of the APA, we sold the assets and assigned certain liabilities that were primarily related to the GDS Business. In December 2011, we disposed of the extended warranty contracts related to the GDS Business, which were outstanding as of the date of the sale of the GDS Business but were not included in the August 2011 transaction. Our consolidated balance sheets and statements of operations have been reclassified, as required, for all periods presented to reflect the GDS Business as a discontinued operation. Cash flows associated with the operation of the GDS Business have been combined within operating, investing and financing cash flows, as appropriate, in our consolidated statements of cash flows. See Note 2.

In August 2009, the Company's Board of Directors decided to discontinue the operations of, and attempt to sell, our Cardiosonix subsidiary. This decision was based on the determination that the blood flow measurement device segment was no longer considered a strategic initiative of the Company, due in large part to positive events in our other device product and drug development initiatives. Our consolidated balance sheets and statements of operations have been reclassified, as required, for all periods presented to reflect Cardiosonix as a discontinued operation. Cash flows associated with the operation of Cardiosonix have been combined within operating, investing and financing cash flows, as appropriate, in our consolidated statements of cash flows. See Note 2.

Notes to the Consolidated Financial Statements

c. **Use of Estimates:** The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

d. **Financial Instruments and Fair Value:** The fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value, giving 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 are described below:

Level 1 – Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;

Level 2 – Quoted prices in markets that are not active or financial instruments for which all significant inputs are observable, either directly or indirectly; and

Level 3 – Prices or valuations that require inputs that are both significant to the fair value measurement and unobservable.

A financial instrument's level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. In determining the appropriate levels, we perform a detailed analysis of the assets and liabilities whose fair value is measured on a recurring basis. At each reporting period, all assets and liabilities for which the fair value measurement is based on significant unobservable inputs or instruments which trade infrequently and therefore have little or no price transparency are classified as Level 3. See Note 3.

The following methods and assumptions were used to estimate the fair value of each class of financial instruments:

(1) Cash, accounts receivable, accounts payable, and accrued liabilities: The carrying amounts approximate fair value because of the short maturity of these instruments.

(2) Note payable to finance company: The fair value of our debt is estimated by discounting the future cash flows at rates currently offered to us for similar debt instruments of comparable maturities by banks or finance companies. We had no notes payable to finance companies at December 31, 2011. At December 31, 2010, the carrying value of this instrument approximated fair value.

(3) Note payable to investor: The carrying value of our debt at December 31, 2011 is presented as the face amount of the note less unamortized discounts. At December 31, 2011, the carrying value of the note payable to investor approximates fair value based on the proximity of the loan date to year-end. See Note 9.

(4) Derivative liabilities: Derivative liabilities are related to certain outstanding warrants which are recorded at fair value. The assumptions used to calculate fair value as of December 31, 2011 and 2010 include volatility, risk-free rate and expected dividends. In addition, we considered non-performance risk and determined that such risk is minimal. Unrealized gains and losses on the derivatives are classified in other expenses as a change in derivative liabilities in the statements of operations. See Note 11.

Notes to the Consolidated Financial Statements

e. **Stock-Based Compensation:** At December 31, 2011, we have instruments outstanding under two stock-based compensation plans; the 1996 Stock Incentive Plan (the 1996 Plan), and the Third Amended and Restated 2002 Stock Incentive Plan (the 2002 Plan). Currently, under the 2002 Plan, we may grant incentive stock options, nonqualified stock options, and restricted stock awards to full-time employees and directors, and nonqualified stock options and restricted stock awards may be granted to our consultants and agents. Total shares authorized under each plan are 1.5 million shares and 10 million shares, respectively. Although instruments are still outstanding under the 1996 Plan, the plan has expired and no new grants may be made from it. Under both plans, the exercise price of each option is greater than or equal to the closing market price of our common stock on the day prior to the date of the grant.

Stock options granted under the 1996 Plan and the 2002 Plan generally vest on an annual basis over one to four years. Outstanding stock options under the plans, if not exercised, generally expire ten years from their date of grant or 90 days from the date of an optionee's separation from employment with the Company. We issue new shares of our common stock upon exercise of stock options.

Stock-based payments to employees and directors, including grants of stock options, are recognized in the consolidated statement of operations based on their estimated fair values. The fair value of each stock option award is estimated on the date of grant using the Black-Scholes option pricing model. Expected volatilities are based on the Company's historical volatility, which management believes represents the most accurate basis for estimating expected future volatility under the current circumstances. Navidea uses historical data to estimate forfeiture rates. The expected term of stock options granted is based on the vesting period and the contractual life of the options. The risk-free rate is based on the U.S. Treasury yield in effect at the time of the grant. The assumptions used to calculate fair value for the years ended December 31, 2011, 2010 and 2009 are noted in the following table:

	2011	2010	2009
Expected volatility	64%-71 %	61%-68 %	73%-91 %
Weighted-average volatility	69 %	66 %	81 %
Expected dividends	—	—	—
Expected term (in years)	5.3-6.3	6.0-6.3	5.5-6.0
Risk-free rate	1.3%-2.4%	1.7%-2.4%	1.8%-2.7%

Compensation cost arising from stock-based awards is recognized as expense using the straight-line method over the vesting period. Restricted shares generally vest upon occurrence of a specific event or achievement of goals as defined in the grant agreements. As a result, we record compensation expense related to grants of restricted stock based on management's estimates of the probable dates of the vesting events. See Note 4.

f. **Cash and Cash Equivalents:** Cash equivalents are highly liquid instruments such as U.S. Treasury bills, bank certificates of deposit, corporate commercial paper and money market funds which have maturities of less than 3 months from the date of purchase. The Company held no cash equivalents at December 31, 2011 or 2010.

g. **Inventory:** All components of inventory are valued at the lower of cost (first-in, first-out) or market. We adjust inventory to market value when the net realizable value is lower than the carrying cost of the inventory. Market value is determined based on estimated sales activity and margins. From time to time, we capitalize certain inventory costs associated with our Lymphoseek product prior to regulatory approval and product launch based on management's judgment of probable future commercial use and net realizable value of the inventory. We could be required to permanently write down previously capitalized costs related to pre-approval or pre-launch inventory upon a change in such judgment, due to a denial or delay of approval by regulatory bodies, a delay in commercialization, or other potential factors. Conversely, our gross margins may be favorably impacted if some or all of the inventory previously expensed becomes available and is used for commercial sale. See Note 6.

Notes to the Consolidated Financial Statements

h. **Property and Equipment:** Property and equipment are stated at cost, less accumulated depreciation and amortization. Property and equipment under capital leases are stated at the present value of minimum lease payments. Depreciation is computed using the straight-line method over the estimated useful lives of the depreciable assets ranging from 3 to 7 years, and includes amortization related to equipment under capital leases, which is amortized over the shorter of the estimated useful life of the leased asset or the term of the lease. Maintenance and repairs are charged to expense as incurred, while renewals and improvements are capitalized. See Note 7.

i. **Intangible Assets:** Intangible assets consist primarily of patents and trademarks. Intangible assets are stated at cost, less accumulated amortization. Patent costs are amortized using the straight-line method over the estimated useful lives of the patents of approximately 5 to 15 years. Patent application costs are deferred pending the outcome of patent applications. Costs associated with unsuccessful patent applications and abandoned intellectual property are expensed when determined to have no recoverable value. We evaluate the potential alternative uses of all intangible assets, as well as the recoverability of the carrying values of intangible assets, on a recurring basis.

j. **Impairment or Disposal of Long-Lived Assets:** Long-lived assets and certain identifiable intangibles are 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 undiscounted cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell. See Notes 2 and 7.

k. **Other Assets:** We defer costs associated with the issuance of notes payable and amortize those costs over the period of the notes using the effective interest method. In 2011 and 2009, we incurred $593,000 and $20,000, respectively, of debt issuance costs related to notes payable. During 2011, 2010 and 2009, we recorded amortization of $2,000, $4,000 and $69,000, respectively, of deferred debt issuance costs. During 2009, we expensed an additional $524,000 of debt issuance costs as a result of debt modification activities. Other assets at December 31, 2011 include deferred debt issuance costs of $591,000. The Company had no deferred debt issuance costs at December 31, 2010. See Note 10.

l. **Derivative Instruments:** Derivative instruments embedded in contracts, to the extent not already a free-standing contract, are bifurcated from the debt instrument and accounted for separately. All derivatives are recorded on the consolidated balance sheet at fair value in accordance with current accounting guidelines for such complex financial instruments. Derivative liabilities with expiration dates within one year are classified as current, while those with expiration dates in more than one year are classified as long term. We do not use derivative instruments for hedging of market risks or for trading or speculative purposes. See Note 11.

m.

Revenue Recognition: We currently generate revenue primarily from grants to support various product development initiatives. We generally recognize grant revenue when expenses reimbursable under the grants have been incurred and payments under the grants become contractually due.

n. **Research and Development Costs:** All costs related to research and development activities are expensed as incurred.

o. **Income Taxes:** Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Due to the uncertainty surrounding the realization of the deferred tax assets in future tax returns, all of the deferred tax assets have been fully offset by a valuation allowance at December 31, 2011 and 2010. Estimated tax liabilities of $6.7 million related to the gain on the sale of discontinued operations and $1.2 million related to income from discontinued operations were fully offset by an estimated tax benefit of $7.9 million related to the loss from continuing operations during 2011. Estimated tax liabilities of $2.1 million related to income from discontinued operations were fully offset by an estimated tax benefit of $2.1 million related to the loss from continuing operations during 2010. An estimated tax benefit of $583,000 related to the impairment loss for discontinued operations and estimated tax liabilities of $1.8 million related to income from discontinued operations were fully offset by an estimated tax benefit of $1.3 million related to the loss from continuing operations during 2009. See Note 13.

Notes to the Consolidated Financial Statements

Current accounting standards include guidance on the accounting for uncertainty in income taxes recognized in the financial statements. Such standards also prescribe a recognition threshold and measurement model for the financial statement recognition of a tax position taken, or expected to be taken, and provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The Company believes that the ultimate deductibility of all tax positions is highly certain, although there is uncertainty about the timing of such deductibility. As a result, no liability for uncertain tax positions was recorded as of December 31, 2011 or 2010 and we do not expect any significant changes in the next twelve months. Should we need to accrue interest or penalties on uncertain tax positions, we would recognize the interest as interest expense and the penalties as a selling, general and administrative expense. As of December 31, 2011, tax years 2008-2011 remained subject to examination by federal and state tax authorities.

p. **Recent Accounting Developments:** In May 2011, the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) issued Accounting Standards Update (ASU) No. 2011-04, Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs (ASU 2011-04). ASU 2011-04 created a uniform framework for applying fair value measurement principles for companies around the world and clarified existing guidance in US GAAP. ASU 2011-04 is effective for interim and annual reporting periods beginning after December 15, 2011 and shall be applied prospectively. We do not expect ASU 2011-04 to have a material effect on our consolidated financial statements, however, it may result in additional disclosures.

In June 2011, the FASB issued ASU No. 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income* (ASU 2011-05), as amended by ASU No. 2011-12, *Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05* (ASU 2011-12). The ASUs increase the prominence of items reported in other comprehensive income (OCI) by eliminating the option to present OCI as part of the statement of changes in stockholders' equity. The amendments require companies to present all non-owner changes in stockholders' equity, either as one continuous statement or as two separate but consecutive statements. The ASUs do not change the current option for presenting components of OCI gross of the effect of income taxes, provided that such tax effects are presented in the statement in which OCI is presented or disclosed in the notes to the financial statements. Additionally, the standard does not affect the calculation or reporting of earnings per share. The amendments are effective for interim and annual reporting periods beginning after December 15, 2011 and are to be applied retrospectively, with early adoption permitted. The Company adopted the provisions of ASU 2011-05 early which only impacted the presentation on the statements of operations and comprehensive income (loss). ASU 2011-12 also only impacts presentation and will have no effect on our financial position or results of operations.

q. Reclassification: Certain prior-year amounts have been reclassified to conform to the current-year presentation.

2. Discontinued Operations

In August 2009, the Company's Board of Directors decided to discontinue the operations of, and attempt to sell, our Cardiosonix subsidiary. This decision was based on the determination that the blood flow measurement device segment was no longer considered a strategic initiative of the Company, due in large part to positive achievements related to our other device product and drug development initiatives. We have not received significant expressions of interest in the Cardiosonix business; however, we are obligated to continue to service and support the Cardiosonix devices through 2013. As such, while we continue to wind down our activities in this area, we expect to continue to generate minimal revenues and incur minimal expenses related to our blood flow measurement device business until a final shutdown of operations or a sale of the business unit is completed.

Notes to the Consolidated Financial Statements

In August 2011, we completed the sale of the GDS Business to Devicor under the terms of the APA that was signed in May 2011. On August 17, 2011, Devicor made an initial cash payment to us of $30.0 million, assumed certain liabilities of the Company associated with the GDS Business as specified in the APA, and agreed to make royalty payments to us of up to an aggregate maximum amount of $20.0 million based on the net revenue attributable to the GDS Business over the course of the next six fiscal years beginning in 2012. The final sale price of $30.3 million includes the initial cash payment of $30.0 million and an additional cash payment related to a net working capital adjustment of $338,000. The proceeds were offset by $2.8 million in investment banking, legal and other fees related to the sale and $2.4 million in net balance sheet dispositions and write-offs.

In December 2011, we disposed of the extended warranty contracts related to the GDS Business, which were outstanding as of the date of the sale of the GDS Business but were not included in the August 2011 transaction. In exchange for transferring the liability related to the extended warranty contracts, which was previously recorded as deferred revenue, we made a cash payment to Devicor of $178,000. At the time of the transfer, we had current and deferred revenue reflected in our financial statements which was being amortized into income on a pro-rata basis over the life of the contracts. As a result of the transfer of obligations to Devicor, we recognized the unamortized deferred revenue of $1.2 million of non-cash income.

We recorded a net gain on the sale of the GDS business and disposal of the related extended warranty contracts of $26.2 million in 2011, which was reduced by estimated tax expense of $6.7 million during 2011.

As a result of our decision to hold Cardiosonix for sale, we reduced all assets and liabilities to their estimated fair value at that time, which resulted in an impairment loss of $1.1 million, primarily related to $1.3 million of intangible assets, $416,000 of inventory, and $30,000 of equipment, offset by $583,000 of related income tax benefit. The impairment loss was included in the loss from discontinued operations for the year ended December 31, 2009.

We estimate an allowance for doubtful accounts based on a review and assessment of specific accounts receivable and write off accounts when deemed uncollectible. The allowance for doubtful accounts at December 31, 2010 was $1,200. At December 31, 2010, approximately 87% of net accounts receivable were due from Devicor and EES. There were no accounts receivable related to discontinued operations at December 31, 2011.

During 2011, 2010 and 2009, we also wrote off $1,000, $65,000 and $2,000, respectively, of excess and obsolete gamma detection device materials.

Deferred revenue consists primarily of non-refundable license fees and reimbursement of past research and development expenses which EES paid us as consideration for extending our distribution agreement with them in prior years. During 2011, 2010 and 2009, we recognized license revenue of $63,000, $100,000, and $100,000, respectively. The unearned license revenue remaining at the date of the sale of the GDS Business was written off as part of the gain on the sale. In addition, deferred revenue includes revenues from the sale of extended warranties covering our medical devices over periods of one to five years. Prior to the disposal of the extended warranty contracts, we recognized revenue from extended warranty sales on a pro-rata basis over the period covered by the extended warranty.

Notes to the Consolidated Financial Statements

As a result of the sale of the GDS Business, we reclassified all related assets and liabilities as assets and liabilities associated with discontinued operations. We also reclassified all remaining assets and liabilities related to discontinued operations of our Cardiosonix subsidiary for all periods presented, the amounts of which are not significant. The following assets and liabilities have been segregated and included in assets associated with discontinued operations or liabilities associated with discontinued operations, as appropriate, in the consolidated balance sheets:

	December 31, 2011	December 31, 2010
Accounts receivable, net	$ 5,650	$ 1,917,213
Inventory, net	—	826,588
Other current assets	4,980	40,839
Assets associated with discontinued operations, current	10,630	2,784,640
Property and equipment, net of accumulated depreciation	—	114,248
Patents and trademarks, net of accumulated amortization	—	60,215
Assets associated with discontinued operations, non-current	—	174,463
Total assets associated with discontinued operations	$ 10,630	$ 2,959,103
Accounts payable	$ 5,400	$ 170,981
Accrued liabilities	4,664	279,167
Deferred revenue, current	—	654,430
Liabilities associated with discontinued operations, current	10,064	1,104,578
Deferred revenue, non-current	—	672,924
Liabilities associated with discontinued operations	$ 10,064	$ 1,777,502

Notes to the Consolidated Financial Statements

In addition, we reclassified revenues and expenses related to the GDS Business and our Cardiosonix subsidiary to discontinued operations for all periods presented. The following amounts, as well as the $26.2 million gain on the sale of the GDS Business and disposal of the related extended warranty contracts and the $1.7 million Cardiosonix impairment in 2009, have been segregated from continuing operations and included in discontinued operations in the consolidated statements of operations:

	Years Ended December 31,		
	2011	2010	2009
Net sales	$7,684,689	$10,140,476	$9,647,160
Cost of goods sold	2,324,427	3,230,575	3,185,584
Gross profit	5,360,262	6,909,901	6,461,576
Operating expenses:			
Research and development	564,194	371,794	635,863
Selling, general and administrative	308,220	258,452	418,111
Total operating expenses	872,414	630,246	1,053,974
Other expense, net	(1,084)	(529)	(800)
Income taxes	(1,157,230)	(2,134,903)	(1,838,312)
Income from discontinued operations	$3,329,534	$4,144,223	$3,568,490

Subsequent to the sale of the GDS Business, the Company re-evaluated its segment disclosures and determined that our radiopharmaceutical products under development constitute our only current line of business.

Notes to the Consolidated Financial Statements

3. Fair Value Hierarchy

The following tables set forth, by level, financial liabilities measured at fair value on a recurring basis:

Liabilities Measured at Fair Value on a Recurring Basis as of December 31, 2011

Description	Quoted Prices in Active Markets for Identical Assets and Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance as of December 31, 2011
Liabilities:				
Derivative liabilities related to warrants, current	$ —	$ 568,930	$ —	$ 568,930

Liabilities Measured at Fair Value on a Recurring Basis as of December 31, 2010

Description	Quoted Prices in Active Markets for Identical Assets and Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance as of December 31, 2010
Liabilities:				
Derivative liabilities related to warrants, current	$ —	$ 405,524	$ —	$ 405,524
Derivative liabilities related to warrants, long-term	—	2,077,799	—	2,077,799
Total derivative liabilities	$ —	$ 2,483,323	$ —	$ 2,483,323

There were no transfers in or out of our Level 1 and Level 2 fair value measurements during the years ended December 31, 2011 or 2010.

There were no Level 3 liabilities outstanding during the year ended December 31, 2011. The following table sets forth a summary of changes in the fair value of our Level 3 liabilities for the year ended December 31, 2010:

Year Ended December 31, 2010

Description	Balance at December 31, 2009	Unrealized Losses	Purchases, Issuances and Settlements	Transfers In and/or (Out)	Balance at December 31, 2010
Liabilities:					
Derivative liabilities related to put options	$ 966,000	$ —	$ (966,000)	$ —	$ —

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Notes to the Consolidated Financial Statements

4. Stock-Based Compensation

For the years ended December 31, 2011, 2010 and 2009, our total stock-based compensation expense was approximately $3.6 million, $598,000 and $445,000, respectively. We have not recorded any income tax benefit related to stock-based compensation for the years ended December 31, 2011, 2010 and 2009.

A summary of the status of our stock options as of December 31, 2011, and changes during the year then ended, is presented below:

	Year Ended December 31, 2011			
	Number of Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value
Outstanding at beginning of year	5,734,500	$ 0.58		
Granted	281,000	3.56		
Exercised	(2,697,833)	0.35		
Forfeited	(2,667)	0.85		
Expired	—	—		
Outstanding at end of year	3,315,000	$ 1.02	4.1 years	$5,576,560
Exercisable at end of year	2,588,817	$ 0.67	2.8 years	$5,061,590

The weighted average grant-date fair value of options granted in 2011, 2010 and 2009 was $2.22, $1.13 and $0.68, respectively. During 2011, 2,697,833 stock options with an aggregate intrinsic value of $9,620,085 were exercised in exchange for issuance of 1,832,673 shares of our common stock, resulting in gross proceeds of $225,010. During 2010, 491,667 stock options with an aggregate intrinsic value of $697,662 were exercised in exchange for issuance of 350,156 shares of our common stock, resulting in gross proceeds of $32,550. During 2009, 465,000 stock options with an aggregate intrinsic value of $282,250 were exercised in exchange for issuance of 400,441 shares of our common stock, resulting in gross proceeds of $148,750. During 2011, 2010 and 2009, we paid tax withholdings related to stock options exercised of $2.8 million, $133,000, and $24,000, respectively. During 2011, 2010 and 2009, the aggregate fair value of stock options vested was $1.9 million, $668,000 and $343,000, respectively.

A summary of the status of our unvested restricted stock as of December 31, 2011, and changes during the year then ended, is presented below:

	Year Ended December 31, 2011	
	Number of Shares	Weighted Average Grant-Date Fair Value
Unvested at beginning of year	2,374,500	$ 1.07
Granted	922,000	3.49
Vested	(1,050,000)	1.27
Forfeited	(4,500)	0.65
Expired	(596,000)	0.80
Unvested at end of year	1,556,000	$ 2.48

During 2011 and 2009, 1,050,000 and 5,000 shares, respectively, of restricted stock vested with aggregate fair values of $4.2 million and $6,000, respectively. No restricted stock vested during 2010.

Notes to the Consolidated Financial Statements

As of December 31, 2011, there was approximately $1.5 million of total unrecognized compensation cost related to stock option and restricted stock awards, which we expect to recognize over remaining weighted average vesting terms of 2.1 years. See Note 1(e).

5. Earnings Per Share

Basic earnings (loss) per share is calculated by dividing net income (loss) attributable to common stockholders by the weighted-average number of common shares and, except for periods with a loss from operations, participating securities outstanding during the period. Diluted earnings (loss) per share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued. Potential common shares that may be issued by the Company include convertible securities, options and warrants.

The following table sets forth the reconciliation of the weighted average number of common shares outstanding to those used to compute basic and diluted earnings (loss) per share for the years ended December 31, 2010 and 2009:

	Basic and Diluted Earnings Per Share Years Ended December 31,		
	2011	2010	2009
Outstanding shares	95,398,961	86,319,913	80,936,711
Effect of weighting changes in outstanding shares	(3,333,635)	(3,218,915)	(5,445,840)
Unvested restricted stock	(1,556,000)	(2,374,500)	(1,719,000)
Adjusted shares	90,509,326	80,726,498	73,771,871

Earnings (loss) per common share for the years ended December 31, 2011, 2010 and 2009 excludes the effects of 55.7 million, 64.1 million and 58.8 million common share equivalents, respectively, since such inclusion would be anti-dilutive. The excluded shares consist of common shares issuable upon exercise of outstanding stock options and warrants, and upon the conversion of convertible debt and convertible preferred stock.

The Company’s unvested stock awards contain nonforfeitable rights to dividends or dividend equivalents, whether paid or unpaid (referred to as “participating securities”). Therefore, the unvested stock awards are included in the number of shares outstanding for both basic and diluted earnings per share calculations. However, due to our loss from continuing operations, 1,556,000, 2,374,500 and 1,719,000 shares of unvested restricted stock were excluded in determining basic and diluted loss per share for the years ended December 31, 2011, 2010 and 2009, respectively,

because such inclusion would be anti-dilutive.

6. Inventory

The components of net inventory at December 31, 2011 and 2010 are as follows:

	2011	2010
Pharmaceutical materials	$482,000	$482,000
Pharmaceutical work-in-process	339,549	150,000
	$821,549	$632,000

During 2011 and 2010, we capitalized $213,000 and $741,000, respectively, of inventory costs associated with our Lymphoseek product. During 2010, we wrote off $634,000 of previously capitalized Lymphoseek inventory due to changes in our projections of the probability of future commercial use for the specific lots previously capitalized or the consumption of the Lymphoseek material in previously unanticipated product development activities.

Notes to the Consolidated Financial Statements

7. Property and Equipment

The major classes of property and equipment are as follows:

	Useful Life	2011	2010
Production machinery and equipment	5 years	$218,205	$218,205
Other machinery and equipment, primarily computers	3 – 5 years	399,587	426,778
Furniture and fixtures	7 years	416,005	423,769
Software	3 years	305,282	213,326
Leasehold improvements	Life of Lease[1]	102,150	84,027
		$1,441,229	$1,336,105

[1] We amortize leasehold improvements over the life of the lease, which in all cases is shorter than the estimated useful life of the asset.

Property and equipment includes $20,000 and $40,000 of equipment under capital leases with accumulated amortization of $11,000 and $21,000 at December 31, 2011 and 2010, respectively. During 2011, 2010 and 2009, we recorded $117,000, $102,000 and $78,000, respectively, of depreciation and amortization related to property and equipment. We recorded net losses of $3,000 in 2011 and less than $1,000 in each of 2010 and 2009 on the disposal of property and equipment.

8. Accrued Liabilities and Other

Accrued liabilities and other at December 31, 2011 and 2010 consist of the following:

	2011	2010
Contracted services	$969,150	$602,704
Compensation	953,641	257,787
Capital lease obligations, current portion	5,572	8,620
Other	159,359	145,019
	$2,087,722	$1,014,130

9. Separation of David Bupp

In March 2011, Neoprobe announced the departure of our then-current President and CEO, David C. Bupp, effective April 15, 2011. The following table summarizes remaining accrued separation costs, including employer payroll tax obligations, related to the provisions of Mr. Bupp's separation agreement, which are included in accrued liabilities and other on the consolidated balance sheet as of December 31, 2011:

	As of December 31, 2011
Separation	$ 180,074
Pro-rated 2011 bonus	60,870
Estimated cost of continuing healthcare coverage	61,875
	$ 302,819

Concurrent with Mr. Bupp's separation, Dr. Mark J. Pykett was named Neoprobe's new President and CEO, effective April 15, 2011.

Notes to the Consolidated Financial Statements

10. Convertible Securities

In July 2007, David C. Bupp, our President and CEO, and certain members of his family (the Bupp Investors) purchased a $1.0 million convertible note (the Bupp Note) and warrants. The Bupp Note bore interest at 10% per annum, had an original term of one year and was repayable in whole or in part with no penalty. The note was convertible, at the option of the Bupp Investors, into shares of our common stock at a price of $0.31 per share. As part of this transaction, we issued the Bupp Investors Series V warrants to purchase 500,000 shares of our common stock at an exercise price of $0.31 per share, expiring in July 2012.

In December 2007, we entered into a Securities Purchase Agreement (SPA) with Platinum Montaur Life Sciences, LLC (Montaur), pursuant to which we issued Montaur a 10% Series A Convertible Senior Secured Promissory Note in the principal amount of $7,000,000, $3.5 million of which was convertible into shares of our common stock at the conversion price of $0.26 per share, due December 26, 2011 (the Series A Note); and a five-year Series W warrant to purchase 6,000,000 shares of our common stock at an exercise price of $0.32 per share.

As a condition of the SPA, Montaur required that the term of the $1.0 million Bupp Note be extended approximately 42 months or until at least one day following the maturity date of the Series A Note. In consideration for the Bupp Investors' agreement to extend the term of the Bupp Note, we agreed to provide security for the obligations evidenced by the amended Bupp Note (the Amended Bupp Note), under the terms of a Security Agreement, dated December 26, 2007, by and between the Company and the Bupp Investors (the Bupp Security Agreement). As further consideration for extending the term of the Bupp Note, we issued the Bupp Investors additional Series V warrants to purchase 500,000 shares of our common stock at an exercise price of $0.32 per share, expiring in December 2012.

In April 2008, following achievement of a funding milestone set in the SPA, we amended the SPA related to the second tranche and issued Montaur a 10% Series B Convertible Senior Secured Promissory Note in the principal amount of $3,000,000, which was convertible into shares of our common stock at the conversion price of $0.36 per share, also due December 26, 2011 (the Series B Note, and hereinafter referred to collectively with the Series A Note as the Montaur Notes); and a five-year Series X warrant to purchase 8,333,333 shares of our common stock at an exercise price of $0.46 per share.

In December 2008, after achievement of a further funding milestone set in the SPA, we issued Montaur 3,000 shares of our 8% Series A Cumulative Convertible Preferred Stock (the Series A Preferred Stock) and a five-year Series Y warrant to purchase 6,000,000 shares of our common stock at an exercise price of $0.575 per share (hereinafter referred to collectively with the Series W warrant and Series X warrant as the Montaur Warrants), for an aggregate

purchase price of $3,000,000. The liquidation preference of the Series A Preferred Stock was $1,000 and the conversion price was set at $0.50, thereby making the shares of Series A Preferred Stock convertible into an aggregate 6,000,000 shares of our common stock, subject to certain adjustments as described in the certificate of designations.

In July 2009, we entered into a Securities Amendment and Exchange Agreement with Montaur, pursuant to which Montaur agreed to the amendment and restatement of the terms of the Montaur Notes, the Series A Preferred Stock, and the Montaur Warrants. The Series A Note was amended to grant Montaur conversion rights with respect to the $3.5 million portion of the Series A Note that was previously not convertible. The newly convertible portion of the Series A Note was convertible into 3,600,000 shares of our common stock at $0.9722 per share. The amendments also eliminated certain price reset features of the Montaur Notes, the Series A Preferred Stock and the Montaur Warrants that had created significant non-cash derivative liabilities on the Company’s balance sheet. In conjunction with this transaction, we issued Montaur a Series AA Warrant to purchase 2.4 million shares of our common stock at an exercise price of $0.97 per share, expiring in July 2014. The change in terms of the Montaur Notes, the Series A Preferred Stock and the Montaur Warrants were treated as an extinguishment of debt for accounting purposes. Following the extinguishment, the Company’s balance sheet reflected the face value of the $10 million due to Montaur pursuant to the Montaur Notes, which approximated fair value at the date of the extinguishment.

Notes to the Consolidated Financial Statements

In June 2010, we entered into a Securities Exchange Agreement with Montaur, pursuant to which Montaur exchanged the Montaur Notes and the Series A Preferred Stock for 10,000 shares of Series B Convertible Preferred Stock (the Series B Preferred Stock), convertible into 32,700,000 shares of common stock. The Series B Preferred Stock is convertible at the option of Montaur, carries no dividend requirement and participates equally with our common stock in liquidation proceeds based upon the number of common shares into which the Series B Preferred Stock is then convertible. As consideration for the exchange, the Company issued additional Series B Preferred Stock which is convertible into 1.3 million shares of common stock. Also in June 2010, we entered into a Securities Exchange Agreement with the Bupp Investors, pursuant to which the Bupp Investors exchanged the Amended Bupp Note for 1,000 shares of Series C Convertible Preferred Stock (the Series C Preferred Stock), convertible into 3,226,000 shares of common stock. The Series C Preferred Stock has a 10% dividend rate, payable quarterly until December 31, 2011, and participates equally with our common stock in liquidation proceeds based upon the number of common shares into which the Series C Preferred Stock is then convertible. The exchange of the Montaur Notes, the Series A Preferred Stock and the Amended Bupp Note were treated as extinguishments for accounting purposes. As a result, the Company recognized a loss on extinguishment of debt of $41.7 million, including the write-off of $966,000 in put option derivative liabilities, and recorded a deemed dividend of $8.0 million during the second quarter of 2010. As a result of these exchange transactions, all security interests in the Company’s assets held by Montaur and the Bupp Investors were extinguished.

In December 2011, we executed a Loan and Security Agreement (the Loan Agreement) with Hercules Technology II, L.P. (Hercules), providing for loans to the Company in two advances totaling $10 million. Pursuant to the Loan Agreement, we issued Hercules: (1) a Secured Term Promissory Note in the principal amount of $7,000,000 (the First Advance), bearing interest at the greater of either (a) the U.S. Prime Rate as reported in The Wall Street Journal plus 6.75%, or (b) 10.0% (effective interest rate at December 31, 2011 was 10.0%), and (2) a Series GG Warrant to purchase 333,333 shares of our common stock at an exercise price of $2.10 per share, expiring in December 2016 (the Series GG Warrant). Additionally, pursuant to the terms of the Loan Agreement, if FDA approval of Lymphoseek occurs on or before June 30, 2012, Navidea has the option to draw a second advance in the principal amount of $3,000,000 (the Second Advance), bearing interest at the same rate and payable on the same terms as the First Advance. The Loan Agreement provides for an interest-only period beginning on December 29, 2011 and expiring on July 1, 2012, provided the interest-only period shall expire on January 1, 2013 upon Navidea’s receipt of FDA approval for Lymphoseek on or before June 30, 2012. The principal and interest is to be repaid in 30 equal monthly installments of principal and interest, payable on the first of each month following the expiration of the interest-only period. The outstanding balance of the debt is due December 1, 2014, or June 1, 2015 if the interest-only period is extended following FDA approval of Lymphoseek. Navidea has the option to pay up to $1.5 million of the principal amount of the debt in stock at a fixed conversion price of $2.77, subject to certain conditions. In addition, Hercules has the option to elect payment for up to another $1.5 million of the principal amount of the debt by conversion at a fixed conversion price of $2.77. The debt is collateralized by a security interest in substantially all of the Company’s assets except for intellectual property, as to which the security interest is in rights to income or proceeds from the sale or licensing thereof. The Loan Agreement also specifies certain covenants including the requirement that Navidea provide certain information, such as financial statements and budgets, on a periodic basis. As of December 31, 2011, we were in compliance with all such covenants.

In accordance with current accounting standards, Hercules' option to convert up to $1.5 million of the debt into stock was evaluated and determined to be a beneficial conversion feature. The beneficial conversion feature of $24,888 was recorded as a discount on the First Advance based on the market price of the Company's stock on the date of the Loan Agreement. In addition, the Series GG Warrant was accounted for as a liability at origination due to the existence of certain provisions in the instrument which will remain in effect for the first 365 days the warrant is outstanding. As a result, we recorded a current derivative liability with an estimated fair value of $520,478 on the date of issuance of the Series GG Warrant. The estimated fair value of the Series GG Warrant was recorded as a discount on the First Advance. Navidea paid or accrued total debt issuance costs of $593,339 including origination, legal, and other costs related to the loan. The total aggregate discounts on the First Advance of $545,366 and the debt issuance costs of $593,339 will be amortized as non-cash interest expense using the effective interest method over the term of the Loan Agreement.

Notes to the Consolidated Financial Statements

During the years ended December 31, 2011, 2010 and 2009, we recorded interest expense of $4,000, $16,000 and $428,000, respectively, related to amortization of the debt discounts and deferred financing costs related to our convertible notes.

11. Derivative Instruments

Effective January 1, 2009, we adopted a new accounting standard which clarified the determination of whether equity-linked instruments (or embedded features), such as our convertible securities and warrants to purchase our common stock, are considered indexed to our own stock. As a result of adopting the new standard, certain embedded features of our convertible securities which were extinguished in the second quarter of 2010, as well as warrants to purchase our common stock, that were previously treated as equity were recorded as derivative liabilities. We do not use derivative instruments for hedging of market risks or for trading or speculative purposes.

In July 2009, we entered into a Securities Amendment and Exchange Agreement with Montaur, pursuant to which Montaur agreed to the amendment and restatement of the terms of the Montaur Notes, the Series A Preferred Stock, and the Montaur Warrants as discussed in Note 10. As a result, the Company reclassified $27.0 million in derivative liabilities related to the Montaur Notes, the Series A Preferred Stock, and the Montaur Warrants to additional paid-in capital. Also in July 2009, Montaur exercised 2,844,319 of their Series Y warrants, which resulted in a decrease in the related derivative liability of $2.2 million. In June 2010, we entered into a Securities Exchange Agreement with Montaur, pursuant to which Montaur exchanged the Montaur Notes and the Series A Preferred Stock for 10,000 shares of Series B Convertible Preferred Stock. As a result of this exchange transaction, the Company wrote off $966,000 in put option derivative liabilities during the second quarter of 2010.

In November 2010, we entered into agreements with certain institutional investors, pursuant to which the investors purchased $6.0 million of our common stock at $1.90 per share. In addition to the common stock, we issued two series of warrants to the investors: (1) one-year Series CC warrants to purchase 1,578,948 shares of our common stock at an exercise price of $2.11 per share, and (2) two-year Series DD warrants to purchase 1,578,948 shares of our common stock at an exercise price of $2.11 per share. The Series CC and Series DD warrants originally contained language that required Navidea to classify the warrants as derivative liabilities, and we recorded them at their estimated fair values totaling $1.2 million. On December 23, 2010, a portion of the Series CC and Series DD warrants were modified to remove the language that had previously required them to be classified as derivative liabilities. As a result of the modification of certain of the Series CC and Series DD warrants, we reclassified $801,000 in derivative liabilities related to those warrants to additional paid-in capital after marking the liabilities to market.

During 2010, 120,000 Series V warrants and 60,000 Series Z warrants were exercised. The Company reclassified $280,000 in derivative liabilities related to these warrants to additional paid-in capital.

In January 2011, certain Series V warrants were modified to remove the language that had previously required them to be classified as derivative liabilities. As a result of the modification of the Series V warrants, we reclassified $1.4 million in derivative liabilities related to those warrants to additional paid-in capital during the first quarter of 2011. Also in January 2011, certain Series CC and Series DD warrants were modified to remove the language that had previously required them to be classified as derivative liabilities. As a result of the modification of the Series CC and Series DD warrants, we reclassified $549,000 in derivative liabilities related to those warrants to additional paid-in capital during the first quarter of 2011.

During 2011, Mr. Bupp and certain members of his family exercised 810,000 Series V warrants in exchange for issuance of 810,000 shares of our common stock, resulting in gross proceeds of $255,600. The net effect of marking the derivative liabilities related to the exercised Series V warrants to market resulted in net increases in the estimated fair values of the derivative liabilities of $119,000, which were recorded as non-cash expense. As a result of the Series V warrant exercises, we reclassified $96,000 in derivative liabilities related to those warrants to additional paid-in capital.

Notes to the Consolidated Financial Statements

Also during 2011, the holders of 60,000 Series Z warrants exercised them on a cashless basis in exchange for issuance of 46,902 shares of our common stock. The net effect of marking the derivative liabilities related to the exercised Series Z warrants to market resulted in net increases in the estimated fair values of the derivative liabilities of $79,000, which were recorded as non-cash expense. As a result of the Series Z warrant exercises, we reclassified $164,000 in derivative liabilities related to those warrants to additional paid-in capital.

In addition, the holders of Series CC warrants exercised them during 2011 in exchange for issuance of 1,578,948 shares of our common stock, resulting in gross proceeds of $3,331,580. Further, the holders of Series DD warrants exercised them during 2011 in exchange for issuance of 1,578,948 shares of our common stock, resulting in gross proceeds of $3,331,580. The net effect of marking the derivative liabilities related to the exercised Series CC and Series DD warrants to market resulted in net increases in the estimated fair values of the derivative liabilities of $752,000, which were recorded as non-cash expense. As a result of the Series CC and Series DD warrant exercises, we reclassified $1.1 million in derivative liabilities related to those warrants to additional paid-in capital. See Note 12(b).

In December 2011, in connection with entering into the Loan Agreement with Hercules, we issued a Series GG Warrant to purchase 333,333 shares of our common stock at an exercise price of $2.10 per share, expiring in December 2016. The Series GG Warrant was accounted for as a liability at origination due to the existence of certain price reset provisions in the instrument which will remain in effect for the first 365 days the warrant is outstanding. As a result, we recorded a current derivative liability with an estimated fair value of $520,478 on the date of issuance of the Series GG Warrant. See Note 10.

Changes in the estimated fair values of our derivative liabilities are recorded in the consolidated statement of operations. The net effect of marking our derivative liabilities to market during the years ended December 31, 2011, 2010 and 2009 resulted in net increases in the estimated fair values of the derivative liabilities of $952,000, $1.3 million and $18.1 million, respectively, which were recorded as non-cash expense. The total estimated fair value of our derivative liabilities was $569,000 and $2.5 million as of December 31, 2011 and 2010, respectively.

12. Equity

a. **Common Stock Purchase Agreement:** In March 2010, we sold to Fusion Capital Fund II, LLC (Fusion Capital), an Illinois limited liability company, 540,541 shares for proceeds of $1.0 million under a common stock purchase agreement, as amended. In connection with this sale, we issued 120,000 shares of our common stock to Fusion Capital as an additional commitment fee. The agreement with Fusion Capital expired on March 1, 2011.

b. **Stock Warrants:** At December 31, 2011, there are 17.6 million warrants outstanding to purchase our common stock. The warrants are exercisable at prices ranging from $0.31 to $2.375 per share with a weighted average exercise price per share of $0.56.

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The following table summarizes information about our outstanding warrants at December 31, 2011:

	Exercise Price	Number of Warrants	**Expiration Date**
Series V	$ 0.31	20,000	July 2012
Series W	0.32	6,000,000	December 2012
Series X	0.46	8,333,333	April 2013
Series AA	0.97	2,400,000	July 2014
Series BB	2.00	300,000	July 2015
Series EE	2.375	134,211	August 2015
Series FF	1.97	30,000	December 2015
Series GG	2.10	333,333	December 2016
	$ 0.56	17,550,877	

During 2009, David C. Bupp, our President and CEO, exercised 50,000 Series Q warrants in exchange for issuance of 50,000 shares of our common stock, resulting in gross proceeds of $25,000. The remaining 325,000 Series Q warrants held by Mr. Bupp expired during the year. During the same period, another Bupp Investor exercised 50,000 Series V warrants in exchange for issuance of 50,000 shares of our common stock, resulting in gross proceeds of $16,000. Also during 2009, certain outside investors exercised a total of 1,480,000 Series U warrants on a cashless basis in exchange for issuance of 848,507 shares of our common stock.

During 2010, a Bupp Investor exercised 120,000 Series V warrants in exchange for issuance of 120,000 shares of our common stock, resulting in gross proceeds of $37,200. Also during 2010, certain outside investors exercised a total of 60,000 Series Z warrants on a cashless basis in exchange for issuance of 37,778 shares of our common stock.

In July 2010, we issued five-year Series BB Warrants to purchase 300,000 shares of our common stock at an exercise price of $2.00 per share to an investment advisory firm in connection with a consulting agreement.

See Notes 10 and 11 for a discussion of Series GG warrant transactions during 2011. See Note 11 for a discussion of Series V, Series Z, Series CC, and Series DD warrant transactions during 2011.

c.

Common Stock Reserved: As of December 31, 2011, we have reserved 54,876,319 shares of authorized common stock for the exercise of all outstanding options, warrants, convertible preferred stock and convertible debt.

13. Income Taxes

As of December 31, 2011 and 2010, our deferred tax assets were approximately $37.7 million and $45.4 million, respectively. The components of our deferred tax assets are summarized as follows:

	As of December 31,	
	2011	2010
Deferred tax assets:		
Net operating loss carryforwards	$29,701,483	$37,677,076
R&D credit carryforwards	7,610,672	6,006,233
Temporary differences	371,610	1,745,473
Deferred tax assets before valuation allowance	37,683,765	45,428,782
Valuation allowance	(37,683,765)	(45,428,782)
Net deferred tax assets	$—	$—

Notes to the Consolidated Financial Statements

Current accounting standards require a valuation allowance against deferred tax assets if, based on the weight of available evidence, it is more likely than not that some or all of the deferred tax assets may not be realized. Due to the uncertainty surrounding the realization of these deferred tax assets in future tax returns, all of the deferred tax assets have been fully offset by a valuation allowance at December 31, 2011 and 2010.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities (including the impact of available carryback and carryforward periods), projected future taxable income, and tax-planning strategies in making this assessment. Based upon the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not that the Company will not realize the benefits of these deductible differences or tax carryforwards as of December 31, 2011.

As of December 31, 2011 and 2010, we had U.S. net operating loss carryforwards of approximately $74.1 million and $88.6 million, respectively. Of that amount, $9.1 million relates to stock-based compensation tax deductions in excess of book compensation expense (APIC NOLs) that will be credited to additional paid-in capital when such deductions reduce taxes payable as determined on a "with-and-without" basis. Accordingly, these APIC NOLs will reduce federal taxes payable if realized in future periods, but NOLs related to such benefits are not included in the table above.

At December 31, 2011 and 2010, we had U.S. R&D credit carryforwards of approximately $7.6 million and $6.0 million, respectively. U.S. net operating loss carryforwards of $16.6 million and $9.5 million and R&D credit carryforwards of $346,000 and $156,000 expired during 2011 and 2010, respectively. The details of our U.S. net operating loss and R&D credit carryforward amounts and expiration dates are summarized as follows:

	As of December 31, 2011	
Expiration	U.S. Net Operating Loss Carryforwards	U.S. R&D Credit Carryforwards
2012	$20,797,107	$ 1,064,623
2013	17,142,781	1,173,387
2014	—	130,359
2015	—	71,713
2016	—	39,128
2017	1,282,447	5,350

2018	337,714	2,905
2019	1,237,146	22,861
2020	3,246,062	218,332
2021	3,127,238	365,541
2022	2,863,443	342,898
2023	2,826,656	531,539
2024	13,753,769	596,843
2025	5,425,180	1,094,449
2026	2,083,722	1,950,744
Total carryforwards	$74,123,265	$ 7,610,672

Notes to the Consolidated Financial Statements

During the years ended December 31, 2011, 2010 and 2009, Cardiosonix recorded losses for financial reporting purposes of $19,000, $15,000 and $328,000, respectively. As of December 31, 2011 and 2010, Cardiosonix had tax loss carryforwards in Israel of approximately $7.6 million. Under current Israeli tax law, net operating loss carryforwards do not expire. Due to the uncertainty surrounding the realization of the related deferred tax assets in future tax returns, all of the deferred tax assets have been fully offset by a valuation allowance at December 31, 2011 and 2010.

Under Sections 382 and 383 of the IRC of 1986, as amended, the utilization of U.S. net operating loss and R&D tax credit carryforwards may be limited under the change in stock ownership rules of the IRC. During 2011, we analyzed past ownership changes as defined by Sections 382 and 383, which have occurred at various points in our history, and concluded that we are not currently subject to any Section 382 or 383 limitations. As such, we believe utilization of our net operating loss carryforwards and tax credit carryforwards will not be limited by changes in ownership.

Reconciliations between the statutory federal income tax rate and our effective tax rate for continuing operations are as follows:

	Years Ended December 31,					
	2011		2010		2009	
	Amount	%	Amount	%	Amount	%
Benefit at statutory rate	$(8,516,176)	(34.0)%	$(19,122,958)	(34.0)%	$(14,721,558)	(34.0)%
Adjustments to valuation allowance	—	—	3,410,056	6.1 %	7,816,084	18.1 %
Loss on extinguishment of debt	—	—	14,179,468	25.2 %	5,343,694	12.3 %
Permanent items and other	636,033	2.5 %	(601,469)	(1.1)%	306,167	0.7 %
Benefit per financial statements	$(7,880,143)		$(2,134,903)		$(1,255,613)	

14. Agreements

a. **Supply Agreements:** In November 2009, we entered into a manufacture and supply agreement with Reliable Biopharmaceutical Corporation (Reliable) for the manufacture and supply of the active pharmaceutical ingredient (API) of Lymphoseek. The initial ten-year term of the agreement expires in November 2019, with options to extend the agreement for successive three-year terms. Either party has the right to terminate the agreement upon mutual written agreement, or upon material breach by the other party which is not cured within 60 days from the date of written notice of the breach. Total purchases under the manufacture and supply agreement were $19,000 and $1.0 million for the years ended December 31, 2011 and 2010. As of December 31, 2011, we have issued purchase orders under the agreement with Reliable for $652,000 of our products for delivery through June 2012.

Research and Development Agreements: During January 2002, we completed a license agreement with the University of California, San Diego (UCSD) for Lymphoseek, a proprietary compound that we believe can be used as a lymph node locating agent in SLNB procedures. The license agreement is effective until the later of the expiration date of the longest-lived underlying patent or January 30, 2023. Under the terms of the license agreement, UCSD has granted us the exclusive rights to make, use, sell, offer for sale and import licensed products as defined in the agreement and to practice the defined licensed methods during the term of the agreement. In

b. consideration for the license rights, we agreed to pay UCSD a license issue fee of $25,000 and license maintenance fees of $25,000 per year. We also agreed to pay UCSD milestone payments related to commencement of clinical trials and successful regulatory clearance for marketing of the licensed products, a 5% royalty on net sales of licensed products subject to a $25,000 minimum annual royalty, fifty percent of all sublicense fees and fifty percent of sublicense royalties. We also agreed to reimburse UCSD for all patent-related costs. Total costs related to the UCSD license agreement were $98,000, $36,000 and $63,000 in 2011, 2010 and 2009, respectively, and were recorded in research and development expenses.

Notes to the Consolidated Financial Statements

During April 2008, we completed a license agreement with UCSD for an expanded field of use allowing Lymphoseek to be developed as an optical or ultrasound agent. The license agreement is effective until the expiration date of the longest-lived underlying patent. Under the terms of the license agreement, UCSD has granted us the exclusive rights to make, use, sell, offer for sale and import licensed products as defined in the agreement and to practice the defined licensed methods during the term of the agreement. We may also sublicense the patent rights, subject to certain sublicense terms as defined in the agreement. In consideration for the license rights, we agreed to pay UCSD a license issue fee of $25,000 and license maintenance fees of $25,000 per year. We also agreed to pay UCSD milestone payments related to commencement of clinical trials and successful regulatory clearance for marketing of the licensed products, a 5% royalty on net sales of licensed products subject to a $25,000 minimum annual royalty, fifty percent of all sublicense fees and fifty percent of sublicense royalties. We also agreed to reimburse UCSD for all patent-related costs. Total costs related to the UCSD license agreement were $28,000, $27,000 and $26,000 in 2011, 2010 and 2009, respectively, and were recorded in research and development expenses.

In December 2011, we executed a license agreement with AstraZeneca AB for AZD4694, a proprietary compound that is primarily intended for use in diagnosing Alzheimer's Disease and other central nervous system disorders. The license agreement is effective until the later of the tenth anniversary of the first commercial sale of AZD4694 or the expiration of the underlying patents. Under the terms of the license agreement, AstraZeneca granted us an exclusive worldwide royalty-bearing license for AZD4694 with the right to grant sublicenses. In consideration for the license rights, we paid AstraZeneca a license issue fee of $5.0 million upon execution of the agreement. We also agreed to pay AstraZeneca up to $6.5 million in contingent milestone payments based on the achievement of certain clinical development and regulatory filing milestones, and up to $11.0 million in contingent milestone payments due following receipt of certain regulatory approvals and the initiation of commercial sales of the licensed product. In addition, we agreed to pay AstraZeneca a royalty on net sales of licensed and sublicensed products. Total costs related to the AstraZeneca license agreement were $5.0 million in 2011, and were recorded in research and development expenses.

Cardiosonix's research and development efforts have been partially financed through grants from the Office of the Chief Scientist of the Israeli Ministry of Industry and Trade (the OCS). Through the end of 2004, Cardiosonix received a total of $775,000 in grants from the OCS. In return for the OCS's participation, Cardiosonix is committed to pay royalties to the Israeli Government at a rate of 3% to 5% of the sales of its products, if any, up to 300% of the total grants received, depending on the portion of manufacturing activity that takes place in Israel. In January 2006, the OCS consented to the transfer of manufacturing as long as we comply with the terms of the OCS statutes under Israeli law. We are not aware of any future performance obligations related to the grants received from the OCS. We do not believe we will be obligated to pay the OCS any amounts greater than any royalties due on future sales in the event that future sales are not sufficient to generate adequate revenue to completely cover the full amount of the grant. However, under certain limited circumstances, the OCS may withdraw its approval of a research program or amend the terms of its approval. Upon withdrawal of approval, Cardiosonix may be required to refund the grant, in whole or in part, with or without interest, as the OCS determines. Through December 2011, we have paid the OCS a total of $80,000 in royalties related to sales of products developed under this program. As of December 31, 2011, we have accrued obligations for royalties totaling less than $1,000.

During January 2005, we completed a license agreement with The Ohio State University (OSU), Cira LLC, and Cira Bio for certain technology relating to activated cellular therapy. The license agreement is effective until the expiration date of the longest-lived underlying patent. Under the terms of the license agreement, OSU has granted the licensees the exclusive rights to make, have made, use, lease, sell and import licensed products as defined in the agreement and to utilize the defined licensed practices. We may also sublicense the patent rights. In consideration for the license rights, we agreed to pay OSU a license fee of $5,000 on January 31, 2006. We also agreed to pay OSU additional license fees related to initiation of Phase 2 and Phase 3 clinical trials, a royalty on net sales of licensed products subject to a minimum annual royalty of $100,000 beginning in 2012, and a percentage of any non-royalty license income. Also during January 2005, we completed a business venture agreement with Cira LLC that defines each party’s responsibilities and commitments with respect to Cira Bio and the license agreement with OSU. In connection with the execution of the option, Cira Ltd. also agreed to assign all interests in the ACT technology in the event of the closing of such a financing transaction.

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c. **Employment Agreements:** We maintain employment agreements with five of our officers. The employment agreements contain termination and/or change in control provisions that would entitle each of the officers to 1.5 to 2.5 times their annual salaries, vest outstanding restricted stock and options to purchase common stock, and continue certain benefits if there is a termination without cause or change in control of the Company (as defined) and their employment terminates. As of December 31, 2011, our maximum contingent liability under these agreements in such an event is approximately $2.4 million. The employment agreements also provide for severance, disability and death benefits.

15. Leases

We lease certain office equipment under a capital lease which expires in 2013. We also lease office space under an operating lease that expires in January 2013.

The future minimum lease payments for the years ending December 31 are as follows:

	Capital Leases	Operating Leases
2012	$6,900	$143,256
2013	5,750	8,930
	12,650	$152,186
Less amount representing interest	1,722	
Present value of net minimum lease payments	10,928	
Less current portion	5,572	
Capital lease obligations, excluding current portion	$5,356	

Total rental expense was $154,000, $125,000 and $115,000 for the years ended December 31, 2011, 2010 and 2009, respectively.

16. Employee Benefit Plan

We maintain an employee benefit plan under Section 401(k) of the Internal Revenue Code. The plan allows employees to make contributions and we may, but are not obligated to, match a portion of the employee's contribution with our common stock, up to a defined maximum. We also pay certain expenses related to maintaining the plan. We recorded expenses related to our 401(k) plan of $56,000, $37,000 and $29,000 during 2011, 2010 and 2009,

respectively.

17. Supplemental Disclosure for Statements of Cash Flows

During the years ended December 31, 2011, 2010 and 2009, we paid interest aggregating $4,000, $136,000 and $163,000, respectively. During the years ended December 31, 2010 and 2009, we issued 347,832 and 1,393,239 shares of our common stock, respectively, as payment of interest on our convertible debt and dividends on our convertible preferred stock. During 2011, 2010 and 2009, we issued 35,233, 53,499 and 80,883 shares of our common stock, respectively, as matching contributions to our 401(k) Plan. During the years ended December 31, 2011, 2010 and 2009, we transferred $25,000, $79,000 and $43,000, respectively, of GDS Business inventory to fixed assets related to the creation and maintenance of a pool of service loaner equipment. During 2010, we prepaid $71,000 in insurance through the issuance of notes payable to finance companies with a weighted average interest rate of 7.0%. During 2009, we purchased equipment under a capital lease totaling $20,000. During the year ended December 31, 2010, we reclassified $223,000 of deferred stock offering costs to additional paid-in capital related to the issuance of our common stock to Fusion Capital. See Note 12(a). Also during the year ended December 31, 2010, we recorded a deemed dividend of $8.0 million related to the exchange of the Series A Preferred Stock for Series B Preferred Stock. See Note 10.

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18. Contingencies

We are subject to legal proceedings and claims that arise in the ordinary course of business. In our opinion, the amount of ultimate liability, if any, with respect to these actions will not materially affect our financial position.

19. Subsequent Events

a. **Option Agreement:** In January 2012, Navidea entered into an option agreement with Alseres Pharmaceuticals, Inc. (Alseres) to license [^{123}I]-E-IAFCT Injection, also called Altropane®, an Iodine-123 radiolabeled imaging agent being developed as an aid in the diagnosis of Parkinson's disease and movement disorders. The option agreement provides Navidea with exclusive rights for a period of up to six months to perform final due diligence and prepare the documentation necessary to enter into a definitive license agreement for [^{123}I]-E-IAFCT. Under the terms of the option agreement, we paid Alseres an option fee of $500,000 for the exclusive right to negotiate a definitive license agreement by June 30, 2012. Navidea may extend the option period through July 31, 2012 for an additional $250,000. The option agreement anticipates that Navidea will issue Alseres 400,000 shares of Navidea common stock upon execution of the definitive license agreement. The option also anticipates that the license agreement will provide for contingent milestone payments of up to $3.0 million, $2.75 million of which will principally occur at the time of product registration or upon commercial sales, and the issuance of up to an additional 1.05 million shares of Navidea stock, 950,000 shares of which are issuable at the time of product registration or upon commercial sales. In addition, the license terms outlined in the option agreement anticipate royalties on net sales of the approved product which are consistent with industry-standard terms.

b. **Operating Lease:** In February 2012, Navidea entered into an operating lease agreement for approximately 3,800 square feet of office space in Andover, Massachusetts, just outside of Boston. The lease term will commence two weeks after completion of space renovation, which is currently expected in March 2012, and continue for 24 months at a monthly base rent of approximately $6,400. We must also pay a pro-rata portion of the utilities and real estate taxes of the building. The new office will house the Company's business development and commercialization team handling, in part, the activities surrounding the anticipated launch of Lymphoseek later this year. Navidea's corporate headquarters, including the clinical, manufacturing, regulatory and administration functions, remains in Dublin, Ohio.