TRANSDERM LABORATORIES CORP
Form 10QSB
June 04, 2008

U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-QSB

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended: June 30, 2007

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

For the transition period from ________ to _________
Commission file number 000-27642

TRANSDERM LABORATORIES CORPORATION
(Exact name of small business issuer as specified in its charter)

Delaware	13-3518345
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

101 Sinking Springs Lane, Emigsville, PA 17318
(Address of principal executive offices)

(717) 764-1191
(Issuer's telephone number)

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

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

Check whether the registrant filed all documents and reports required to be filed by Section l2, 13 or 15(d) of the Exchange Act after the distribution of securities under a plan confirmed by a court. Yes o No o

APPLICABLE ONLY TO CORPORATE ISSUERS

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: At June 2, 2008, there were 40,000,000 shares of common stock outstanding.

Transitional Small Business Disclosure Format (Check one): Yes o No x

PART I — FINANCIAL INFORMATION

Item 1. Financial Statements.

ITEM 1. FINANCIAL STATEMENTS

Index to Consolidated Financial Statements.

TRANSDERM LABORATORIES CORPORATION
CONSOLIDATED BALANCE SHEETS
(In thousands, except per share amounts)

	June 30, 2007 (Unaudited)	December 31, 2006
ASSETS		
CURRENT ASSETS		
Cash	$ 135	$ 1,145
Accounts receivable	1,065	1,885
Inventories	837	937
Other current assets	150	20
Total Current Assets	2,187	3,987
PROPERTY, PLANT AND EQUIPMENT, net	1,276	1,528
MORTGAGE ESCROW DEPOSIT	201	201
TOTAL ASSETS	$ 3,664	$ 5,716
LIABILITIES AND STOCKHOLDERS' DEFICIENCY		
CURRENT LIABILITIES		
Accounts payable	$ 85	$ 147
Royalties payable	7,072	7,321
Other liabilities	862	1,291
Current portion of long-term debt	41	40
Subordinated promissory note	7,000	7,000
Redeemable preferred stock	8,500	8,500
Preferred stock dividends payable	5,937	5,639
Total Current Liabilities	29,497	29,938
LONG-TERM LIABILITIES		
Long-term payable - Health-Chem	9,879	9,231
Mortgage payable	1,299	1,318
Payable to affiliate	666	666
Note payable	167	167
Total Long-Term Liabilities	12,011	11,382
COMMITMENTS		
PREFERRED STOCK	0	0
STOCKHOLDERS' DEFICIENCY		
Common stock, par value $.001 per share; 60,000,000 shares authorized; 40,000,000 shares issued and outstanding	40	40
Accumulated deficit	<37,884>	<35,644>
Total Stockholders' Deficiency	<37,844>	<35,604>

TOTAL LIABILITIES AND STOCKHOLDERS' DEFICIENCY	$	3,664	$	5,716

See Notes to Consolidated Financial Statements.

TRANSDERM LABORATORIES CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)
(In thousands, except per share amounts)

		Six Months Ended June 30, 2007		2006
REVENUES:				
Product sales	$	2,254	$	2,919
Product development revenue		327		92
Total revenues		2,581		3,011
COSTS AND EXPENSES:				
Cost of sales – royalties		840		536
Cost of sales – other		1,909		1,695
Selling, general and administrative		1,402		880
Research and development		216		258
LOSS FROM OPERATIONS		<1,786>		<358>
Interest income <expense>, net		<564>		<511>
Other income <expense>, net		408		0
LOSS FROM OPERATIONS BEFORE TAXES AND MINORITY INTEREST		<1,942>		<869>
Minority interest		0		0
Income tax expense		0		0
NET LOSS		<1,942>		<869>
PREFERRED DIVIDENDS		298		298
NET LOSS APPLICABLE TO COMMON STOCKHOLDERS	$	<2,240>	$	<1,167>
NET LOSS PER COMMON SHARE (BASIC & DILUTED)	$	<.06>	$	<.03>
Average number of common shares outstanding: (in thousands)				
Basic		40,000		40,000
Diluted		40,000		40,000

See Notes to Consolidated Financial Statements.

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TRANSDERM LABORATORIES CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)
(In thousands, except per share amounts)

	Three Months Ended June 30,			
		2007		2006
REVENUES:				
Product sales	$	1,105	$	1,300
Product development revenue		59		87
Total revenues		1,164		1,387
COSTS AND EXPENSES:				
Cost of sales – royalties		577		238
Cost of sales – other		978		781
Selling, general and administrative		953		412
Research and development		98		138
LOSS FROM OPERATIONS		<1,442>		<182>
Interest income <expense>, net		<287>		<253>
Other income <expense>, net		408		0
LOSS FROM OPERATIONS BEFORE TAXES AND MINORITY INTEREST		<1,321>		<435>
Minority interest		0		0
Income tax expense		0		0
NET LOSS		<1,321>		<435>
PREFERRED DIVIDENDS		149		149
NET LOSS APPLICABLE TO COMMON STOCKHOLDERS	$	<1,470>	$	<584>
NET LOSS PER COMMON SHARE (BASIC & DILUTED)	$	<.04>	$	<.01>
Average number of common shares outstanding: (in thousands)				
Basic		40,000		40,000
Diluted		40,000		40,000

See Notes to Consolidated Financial Statements.

TRANSDERM LABORATORIES CORPORATION
CONSOLIDATED CASH FLOW STATEMENTS (Unaudited)
(In thousands)

	Six Months Ended June 30,			
		2007		2006
CASH FLOWS FROM OPERATING ACTIVITIES:				
Net loss applicable to common stockholders	$	<2,240>	$	<1,167>
Adjustments to reconcile net loss to net cash provided by operating activities:				
Depreciation and amortization		160		158
Preferred stock dividends payable		298		298
Write-off of property, plant and equipment		92		0
Changes in:				
Accounts receivable		820		2,045
Inventories		100		<276>
Other current assets		<130>		23
Mortgage escrow deposit		0		<5>
Accounts payable		<62>		<125>
Royalties payable		<249>		537
Other liabilities		<429>		<1,266>
Net cash <used for> provided by operating activities		<1,640>		222
CASH FLOWS FROM INVESTING ACTIVITIES:				
Additions to property, plant and equipment		0		<105>
Net cash used for investing activities		0		<105>
CASH FLOWS FROM FINANCING ACTIVITIES:				
Borrowings from affiliates, net		648		267
Long-term debt payments		<18>		<24>
Net cash provided by financing activities		630		243
NET <DECREASE> INCREASE IN CASH		<1,010>		360
Cash at beginning of period		1,145		759
Cash at end of period	$	135	$	1,119
Supplemental Disclosures of Cash Flow Information:				
Cash paid during the period for:				
Interest	$	93	$	86

See Notes to Consolidated Financial Statements.

TRANSDERM LABORATORIES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1. Basis of Presentation

Transderm Laboratories Corporation ("Transderm") engages in the development, manufacture and marketing of transdermal drug delivery systems. Transderm operates principally through its 98.5% owned subsidiary, Hercon Laboratories Corporation ("Hercon", which together with Transderm is referred to collectively as the "Company"). Transderm is 90% owned by Health-Chem Corporation ("Health-Chem" and together with Transderm, Hercon and Health-Chem's other subsidiaries, the "Group").

As of June 30, 2007, the Company's sole product and continuing source of revenues were transdermal nitroglycerin patches (the "Hercon products") used for transdermal relief of the vascular and cardiovascular symptoms related to angina pectoris which it has manufactured and sold pursuant to the terms of a license agreement between Key Pharmaceuticals, Inc. ("Key") and Hercon entered into in March 2000 (the "Key License"). On April 26, 2007, Key terminated the Key License for failure to pay royalties and sued the Company for accrued royalties owed. In May 2007, the Company and Key entered into a Final Judgment On Consent which, among other things, granted the Company a limited right to manufacture and sell the Hercon Products through August 16, 2007 and outlined a financial settlement between Key and Hercon as to royalties owed under the License Agreement and that contemplated that the Company would discontinue manufacturing and selling the Hercon Products after August 16, 2007. Over the ensuing months, Key periodically extended the time during which the Company could manufacture and sell the Hercon Products under the Key License. On April 21, 2008, the Company and Key entered into a Settlement Agreement that entitles the Company to manufacture and sell transdermal products under the Key License indefinitely, subject to the Company's continued satisfaction of the terms of such agreement, which consists principally of the payment of an aggregate of $425,000 in seven equal installments of $60,714.29, the first of which is due and owing on or before July 21, 2008 and the remaining installments to be due and owing on or before October 21, 2008, January 21, 2009, April 21, 2009, July 21, 2009, October 21, 2009 and December 21, 2009. For all periods presented in this report, 100% of the net product sales reported as revenue in the consolidated statements of operations was generated by products sold under the Key License and any loss of or inability to manufacture and sell products under the Key License would have a material negative impact on our operations.

The Company also generates revenues from research and development activities it undertakes for client companies and will be the contract manufacturer of these products if United States Food and Drug Administration ("FDA") approval is obtained.

The accompanying unaudited consolidated financial statements include the accounts of Transderm and Hercon. As of December 31, 2004, the consolidated financial statements also include a Variable Interest Entity ("VIE"), York Realty Leasing LLC, of which Transderm is the primary beneficiary as further described in Note 7. All significant intercompany accounts and transactions, including those involving the VIE, have been eliminated in consolidation. The Company is a 90% owned subsidiary of Health-Chem Corporation ("Health-Chem").

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America for interim financial information. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles in the United States for full year financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included and are of a normal, recurring nature. Operating results for the six month period ended June 30, 2007 are not necessarily indicative of the results that may be expected for the year ended December 31, 2007. These consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto that are included in the Company’s Annual Report on Form 10-KSB for the fiscal period ended December 31, 2006.

2. Cash Management

The Company participates in Health-Chem’s cash management practice, wherein all cash requirements are borrowed from Health-Chem and all excess cash is advanced to Health-Chem. The intercompany balance was $9,879,000 at June 30, 2007. Interest is charged based upon the average outstanding intercompany balance and interest rate on Health-Chem’s debt. The average interest rate charged was 10.375% during both the six months ended June 30, 2007 and 2006.

3. Expenses Charged by Health-Chem

Pursuant to a Corporate Services Agreement between the Company and Health-Chem, Health-Chem pays for certain administrative expenses on behalf of the Company for which Health-Chem is reimbursed. These expenses are comprised primarily of an allocation of corporate services including executive, professional, legal and accounting. The allocation of these costs, approximately $428,000 and $176,000 for the six months ended June 30, 2007 and 2006, respectively, reflect Health-Chem’s estimate of their cost for these services based upon a method (allocation based upon the Company’s net sales as a percentage of Health-Chem’s consolidated net sales) which is considered by the Company to be reasonable. The Company estimates that these expenses, on a stand-alone basis, would not have been materially different from the costs allocated.

4. Per Share Information

Basic and diluted earnings per share are computed based upon the weighted average number of common shares outstanding during each period after adjustment for any dilutive effect of the Company's stock options.

5. Stock Options

In accordance with SFAS No. 123, *Accounting for Stock-Based Compensation* and SFAS No. 148, *Accounting for Stock-Based Compensation-Transition and Disclosure*, the Company accounts for its stock option plans under the intrinsic-value-based method as defined in APB No. 25, *Accounting for Stock Issued to Employees*. The following table illustrates the effect on net earnings and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation (in thousands, except per share amounts):

		Six Months Ended June 30, 2007		2006		Three Months Ended June 30, 2007		2006
Net loss applicable to common stockholders, as reported:	$	<2,240>	$	<1,167>	$	<1,470>	$	<584>
Add: Stock-based compensation expense recognized under the intrinsic value method		0		0		0		0
Deduct: Stock-based compensation expense determined under fair value based method		0		0		0		0
Pro forma net loss applicable to common stockholders	$	<2,240>	$	<1,167>	$	<1,470>	$	<584>
Net loss per common share:								
Basic – as reported	$	<.06>	$	<.03>	$	<.04>	$	<.01>
Basic – pro forma	$	<.06>	$	<.03>	$	<.04>	$	<.01>
Diluted – as reported	$	<.06>	$	<.03>	$	<.04>	$	<.01>
Diluted – pro forma	$	<.06>	$	<.03>	$	<.04>	$	<.01>

6. Going Concern

As of June 30, 2007, the Company’s financial and operating condition raised significant doubt about its ability to continue as a going concern. At said date, the Company had aggregate debts and liabilities of $41,508,000 and had a working capital deficiency of $27,310,000. These debts and liabilities include $7,072,000 of royalties due under the Key License and $31,473,000 to Health-Chem. The Company has sustained operating losses in each of the last three years.

In addition, at June 30, 2007 Health-Chem owes $11,779,000 under outstanding debentures which became due in 1999 and under which it currently is in default, which exerts pressure on the financial condition of the Group as a whole.

The Group has been able to continue to operate over the last several years because it has not made any payments under the debentures since 1999 and because it did not make any royalty payments under the Key License since its inception in March 2000 until May 2007. Apart from these obligations, the Group has been paying its other current debts and liabilities as they become due from cash flow generated from operations. The Group does not have cash on hand to repay the amount due under the debentures.

The Company’s financial condition has prevented it from securing financing or obtaining loans from which it could repay all or a portion of its liabilities. Moreover, as previously noted, as of June 30, 2007, the Company’s sole product and continuing source of revenues was a transdermal nitroglycerin patch and the Company does not have any business prospects for the foreseeable future. If the Company does not abide by the terms of the Settlement Agreement, including its obligations to make quarterly cash payments going forward, the Company could lose its right to manufacture and sell transdermal products under the Key License (until the expiration of the patent on February 16, 2010), and will have no other source of revenue. In light of the uncertainty relating to the Company’s ability to continue operating without the benefit of a license to utilize Key’s technology in its transdermal patch products, Transderm and/or Hercon may have to seek protection under federal bankruptcy laws in which case it would not be able to continue as a going concern.

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Management has not developed a firm plan for addressing the conditions that give rise to its ability to continue operating as a going concern, but at a minimum will:

- seek to develop other business opportunities for the Company, in the pharmaceutical industry or otherwise;
- investigate the possibility of selling Hercon Laboratories Corporation;
- seek to raise working capital through borrowing or through issuing equity; and
- evaluate new directions for the Company.

Management will continue to develop and modify its plans to adapt to business and financial conditions as they evolve. However, management can offer no assurance that it will be successful in developing a plan which permits the Company to continue as a going concern. The accompanying consolidated financial statements do not include any adjustments that might result from the outcome of these uncertainties.

7. Property, Plant and Equipment

In December 2004, the Company sold its real property, buildings, improvements and equipment located in Emigsville, Pennsylvania to York Realty Leasing LLC, an affiliated company, for a sale price of $1.9 million. Concurrent with the sale, the Company entered into a 15-year net lease with York Realty Leasing LLC for the property expiring in December 2019, which can be extended by the Company for an additional five years. The agreement provides for a Company repurchase option at a price of $1,995,000. The base annual lease cost during the initial 15 year term is $212,400, and the base lease expense for the remaining term of the lease is as follows: 2007 - $212,400; 2008 - $212,400; 2009 - $212,400; 2010 - $212,400; 2011 - $212,400; and 2012 and thereafter - $1,699,200. In December 2002, the Company received an appraisal for the real property, including the structures and appurtenances, which appraised the market value of the property at $1,850,000. The proceeds from the sale were used to satisfy a $1.6 million first mortgage associated with the property and to substantially pay off a $367,500 second mortgage, a portion of which was held by related parties. Andy Yurowitz, the Company's Chairman of the Board, President, Chief Executive Officer and a member of the Board of Directors, is a 50% owner of York Realty Leasing LLC. As a result of Financial Interpretation 46(R), effective as of December 31, 2004, the Company's consolidated balance sheet includes the assets and liabilities of York Realty Leasing LLC. In December 2005, York Realty Leasing LLC obtained a $1.4 million mortgage on this property with a financial institution.

In September 2007, subsequent to the close of the period covered by this report, Andy Yurowitz sold his 50% interest in York Realty Leasing LLC, as more fully described in Note 12 - Subsequent Events.

8. Settlement Liability: Royalties

During March 2006, the Company received notice from Key that it was in default under the License Agreement for failing to make royalty payments due. The License Agreement includes a provision affording Key the right to terminate the License Agreement if a breach of the agreement was continuing for thirty days after the receipt from Key of notice of and a demand to cure the breach. Hercon did not have the financial resources to pay the accrued royalties within the prescribed time and, on April 26, 2007, Key terminated the License and Hercon's right to manufacture and sell products utilizing its technology.

On April 27, 2007, Key filed a complaint against Hercon in the United States District Court, District of New Jersey (the "Court") demanding, among other things, that Hercon pay accrued royalties under the License Agreement (the "Complaint").

On May 23, 2007, the Court entered a Final Judgment On Consent between Key and Hercon (the “Consent Judgment”) which set aside the complaint filed by Key against the Company on April 26, 2007 (the “Complaint”) and served as the basis for settling the amount due by Hercon to Key under the License Agreement and governed the relationship between the parties thereafter. The Consent Judgment was predicated on Hercon’s intention to wind down and cease business operations by August 16, 2007 while remaining operational until such date in order to maximize the value of its assets and inventory for the benefit of its creditors. Under the Consent Judgment, the parties agreed, among other things, that (i) Hercon owed Key accrued royalties in the amount of $8,000,000 (the “Judgment Amount”); (ii) Hercon would have a limited right to operate under the License Agreement until August 16, 2007, provided that Hercon paid to Key the sum of $500,000 upon the execution of the Consent Judgment, which sum Hercon paid as ordered on May 23, 2007, which, under the Consent Judgment, reduced the Judgment Amount to $7 million; and (iii) any additional payments made to Key to satisfy the Consent Judgment would reduce the Judgment Amount by twice as much. Hercon’s payment of $500,000 pursuant to the Consent Judgment resulted in a $1,000,000 reduction in the Judgment Amount, thus generating a forgiveness of debt of $500,000. Hercon has recorded this $500,000 forgiveness of debt as other income. The $7 million Judgment Amount is included in the June 30, 2007 royalties payable balance of $7,072,000. The Consent Judgment increased the amount due by $332,000 to a total of $8,000,000.

On several occasions subsequent to June 30, 2007, Key periodically extended the time during which the Company could manufacture and sell the Hercon Products under the Key License. On April 21, 2008, the Company and Key entered into a Settlement Agreement that entitles the Company to manufacture and sell transdermal products under the Key License indefinitely, subject to the Company’s continued satisfaction of the terms of such agreement. This Settlement Agreement is more fully described in Note 12 - Subsequent Events.

9. Commitments & Contingencies

Approximately forty-five percent of the Company’s employees are covered by a collective bargaining agreement with a local unit of the Retail Wholesale and Department Store Union, AFL-CIO (“R.W.D.S.U.”). The R.W.D.S.U. agreement is for a three year period ending December 10, 2007. The contract is subject to annual renewal thereafter and acknowledges that the R.W.D.S.U. is the exclusive bargaining agent for the Company’s regular production employees, excluding all other employees including but not limited to supervisors, foremen, clerical employees, time-keepers, watchmen, guards, maintenance personnel and part-time employees.

Certain raw materials and components used in the manufacture of our products are available from limited sources, and, in some cases, a single source. Generally, regulatory authorities must approve raw material sources for transdermal products. Without adequate approved supplies of raw materials or packaging supplies, our manufacturing operations could be interrupted until another supplier is identified, our products approved and trading terms with it negotiated. We may not be able to identify an alternative supplier and any supplier that we do identify may not be able to obtain the requisite regulatory approvals in a timely manner, or at all. Furthermore, we may not be able to negotiate favorable terms with an alternative supplier. Any disruptions in our manufacturing operations from the loss of an approved supplier may cause us to incur increased costs and lose revenues and may have an adverse effect on our relationships with our partners and customers, any of which could have adverse effects on our business and results of operations. Our business also faces the risk that third party suppliers may supply us with raw materials that do not meet required specifications, which, if undetected by us, could cause our products to test out of specification and require us to recall the affected product.

We market all of our products through a single marketing representative. If we were to lose the services of such marketing agent for any reason or said entity does not maintain a steady demand for our product, and we are unable to identify an adequate replacement, our business, results of operations and financial condition would be materially adversely affected.

We rely on insurance to protect us from many business risks, including product liability, business interruption, property and casualty loss and employment practices liability. The cost of insurance has risen significantly in recent years. In response, we may increase deductibles and/or decrease certain coverages to mitigate these costs. There can be no assurance that the insurance that we maintain and intend to maintain will be adequate, or that the cost of insurance and limitations in coverage will not adversely affect our business, financial position or results of operations. Furthermore, it is possible that, in some cases, coverage may not be available at any price.

10. Litigation

On January 4, 2008, subsequent to the close of the period covered by this report, Transderm filed a Complaint for Declaratory Relief, Breach of Contract and Monetary Damages against York Realty Leasing LLC, as more fully described in Note 12 – Subsequent Events.

On January 24, 2008, subsequent to the close of the period covered by this report, the Company filed a Motion to Vacate Consent Judgment seeking to vacate the Consent Judgment because, among other things, the Consent Judgment was not properly authorized or consented to by the Company. On January 25, 2008, also subsequent to the close of the period covered by this report, the Company filed an Order to Show Cause Seeking Temporary Restraints under which it sought injunctive relief to prevent Key from enforcing the Consent Judgment based upon the likelihood that the Company would prevail on the Motion to Vacate the Consent Judgment. See Note 12 - Subsequent Events for a further discussion of these actions.

On February 25, 2008, subsequent to the close of the period covered by this report, Andy Yurowitz, a director and the former chief executive of Health-Chem and each of its subsidiaries, served each of Health-Chem and Hercon with a summons without complaint which was filed in The Supreme Court of the State of New York, Kings County on February 7, 2008, as more fully described in Note 12 - Subsequent Events.

11. Other Income <Expense>, Net

Other income <expense>, net for the six months ended June 30, 2007 was $408,000. This amount consists of income of $500,000 related to the execution of the Consent Judgment, as more fully described in Note 8 - Settlement Liability: Royalties, partially offset by a loss of $92,000 related to the write-off of uncompleted construction.

12. Subsequent Events

On July 23, 2007, Key and Hercon entered into a letter agreement whereby Key granted Hercon's request to extend its ability to operate under the Consent Judgment. Key has agreed to extend Hercon's limited right to operate under the Consent Judgment through November 16, 2007 subject to Hercon's payment of $150,000 in three monthly installments of $50,000 in immediately available funds to be received by Key by August 18, 2007, September 15, 2007 and October 13, 2007, respectively. Such payments are to be deemed additional consideration and shall not affect Hercon's obligation to comply with all of its obligations under the Consent Judgment, which remains in full force and effect. The payments required by the letter agreement shall reduce the principle due under the Consent Judgment by the amount of the actual payment. Additional payments against principle made by Hercon and received by Key by November 16, 2007, excluding the $150,000 due under the letter agreement and any royalties that are otherwise due pursuant to the limited license granted under the Consent Judgment, shall reduce the Consent Judgment by twice the amount of such additional payment. Hercon has made the required August 18, 2007, September 15, 2007 and October 13, 2007 installment payments. On November 8, 2007, prior to its termination by the Company, McTevia & Associates entered into a letter of intent with a third party that describes a transaction in which such party would acquire the Consent Judgment from Key for the purposes of acquiring the assets of Hercon and its existing business as a going concern through a consensual foreclosure under the Consent Judgment (the "Letter of Intent"). The transactions contemplated by the Letter of Intent were subject to numerous conditions, including the third party's ability to enter into agreements and secure the required regulatory approvals that would allow it seamlessly to continue the operation of Hercon's business at its current facilities. By letter dated December 3, 2007, the Company notified the third party that McTevia did not have the power or authority to enter into the Letter of Intent and that such document is not a binding and valid agreement of the Company or of any of its constituent corporations. On November 21, 2007, Key advised the Company that it would continue to forebear from enforcing its rights under the Consent Judgment solely to permit a third party to complete due diligence relating to the Company in connection with such party's proposed purchase of the Consent Judgment from Key. By letter dated December 28, 2007, the Company (i) requested that Key agree to forebear from executing on the Consent Judgment retroactive from November 16, 2007 and for an additional 90 days to commence on the date that such extension was to have been granted, if at all, and (ii) advised Key that it would submit a proposal to settle or satisfy the Consent Judgment in an economically feasible manner and continue operations. By letter dated January 18, 2008, representatives of Key advised Hercon that it had rejected Hercon's request for an extension of the limited right to operate under the Consent Judgment and that Hercon was required to immediately cease manufacturing and selling transdermal nitroglycerin patch products which were the subject of the License Agreement. The Company discontinued selling the transdermal nitroglycerin patch products as of the close of business on January 18, 2008 and discontinued manufacturing the transdermal nitroglycerin patch products as of the close of business on January 21, 2008. On January 24, 2008, the Company filed a Motion to Vacate Consent Judgment seeking to vacate the Consent Judgment because, among other things, the Consent Judgment was not properly authorized or consented to by the Company. On January 25, 2008, the Company filed an Order to Show Cause Seeking Temporary Restraints under which it sought injunctive relief to prevent Key from enforcing the Consent Judgment based upon the likelihood that the Company would prevail on the Motion to Vacate the Consent Judgment. On January 25, 2008, counsel for Key informally notified the Company that it would not seek sanctions against the Company for any resumption of operations pending resolution of the Company's motion for interim relief, and the Company immediately resumed manufacturing and selling transdermal patches. On February 12, 2008, the Company and Key entered into a letter agreement whereby Key agreed to extend the Company's limited right to operate under the Consent Judgment through March 10, 2008 in exchange for the Company's immediate withdrawal, with prejudice, of the Motion to Vacate Consent Judgment and Order to Show Cause Seeking Temporary Restraints and the Company's acknowledgment that the Consent Judgment is legally valid and binding upon the Company. In connection with the negotiation of the February 12, 2008 letter, Key agreed to consider any proposal made by the Company to settle or satisfy the Consent Judgment without foreclosing its option to accept a third party offer to purchase the Consent Judgment. Since the execution of the February 12, 2008 letter agreement, the Company had been in negotiations with Key with respect to the Company's possible settlement of the Consent Judgment. On March 11, 2008, Key agreed to extend the Company's limited right to operate under the Consent Judgment through March 24, 2008 to permit the parties to continue negotiating a resolution to Key's claims, including the possible settlement of the Consent Judgment by the Company from Key. On April 21, 2008, the Company and Key entered into a Settlement Agreement that entitles the Company to manufacture and sell transdermal products under the Key License indefinitely, subject to the Company's continued satisfaction of the terms of such agreement. Under the Settlement Agreement, the Company agreed to pay Key an aggregate of $1,425,000, of which the Company paid Key $1,000,000 upon the execution of the Settlement Agreement and agreed to pay the balance of $425,000 in seven equal installments of $60,714.29, the first of which is due and owing on or before July 21, 2008 and the remaining installments to be due and owing on or before October 21, 2008, January 21, 2009, April 21, 2009, July 21, 2009, October 21, 2009 and December 21, 2009. The amount paid and payable under the Settlement Agreement was allocated as follows: $650,000 was applied to the purchase of the Consent Judgment; $350,000 was applied to the satisfaction of all royalties due for the period October 1, 2007 through the execution of the Settlement Agreement; and payments aggregating $425,000 will be applied to the satisfaction of all royalties that may become due under the License Agreement from the date of the Settlement Agreement through the termination of the License Agreement.

The Settlement Agreement further provides that:

- The License Agreement will continue in effect until it expires on February 16, 2010 as modified by the Settlement Agreement so that all royalties which become due after April 21, 2007 under the License Agreement would be satisfied by the additional payments to be made in the future totaling $425,000, as described above, and that the Company would no longer be required to account to Key for royalties due after April 21, 2008;

- The Consent Judgment, including Key's right to receive $8,000,000 in past due royalty payments thereunder, reduced by a credit of $1,150,000 in respect of payments by Hercon prior to entering into the Settlement Agreement, would remain in full force and effect until Key received payment of all amounts owed under the Settlement Agreement;

- The Company may not assign, delegate or otherwise transfer the License Agreement or any of its rights or obligations arising under the License Agreement without the prior written consent of Key;

- All agents, officers, directors and stockholders of all parties to the Settlement Agreement were released and all such parties agreed to hold the others harmless from any and all claims that were or could have been asserted in the action brought by Key or in the Action or in relation to the Consent Judgment or any claims which would or could have been asserted by or against the parties prior to the execution of the Settlement Agreement, provided, however, that if at any time, any of the monies paid to Key were set aside as a preference under the bankruptcy laws, or were otherwise ordered to be disgorged from Key in connection with legal proceedings that involve the Company or any of its affiliates, Key's release would be deemed null and void, if the Company was unable to cure the setting aside of the monies paid. In the event the disgorgement is not cured, avoided, or otherwise recovered in connection with a bankruptcy case involving any corporate constituent of the Company, Key would have an allowed claim in such bankruptcy case for the full amount of the Consent Judgment less any amounts previously paid to and retained by it;

- Any breaches by the Company of its obligations under the Settlement Agreement which were not cured within 25 days after written notice requesting cure would entitle Key to enforce the Consent Judgment, and any payments made by the Company to Key pursuant to the Settlement Agreement would be applied towards the satisfaction of the Consent Judgment; and

- Andrew Levinson and Manfred Mayerfeld, directors of each constituent corporation of the Company, agreed that they would be jointly and severally liable to Key, if within 90 days of the date that Key received the first payment, a proceeding were commenced against Hercon or Key and Key was thereafter ordered in such proceeding, pursuant to a final, non-appealable order, to return or disgorge all or any portion of the initial $1,000,000 payment under the Settlement Agreement. The amount for which either or both would be liable would be the lesser of the amount ordered to be returned or disgorged or the amount of that initial payment. Any obligations of Mr. Levinson or Mr. Mayerfeld would be deemed to be extinguished if within 90 days of the date Key received the first payment, it did not receive notice of an action, potential action or other proceeding requiring it to return or disgorge such payment or any portion thereof and such action or proceeding is not commenced. At a meeting of the Board of Directors of the Company (the "Board") held on April 16, 2008, at which the Board approved the terms of settlement described above, the Board agreed to defer consideration of appropriate collateral to be provided to Messrs. Levinson and Mayerfeld for their guarantee and appropriate compensation to them therefor.

If the Company does not abide by the terms of the Settlement Agreement, including its obligations to make quarterly cash payments going forward, the Company could lose its right to manufacture and sell transdermal products under the Key License (until the expiration of the patent on February 16, 2010), and will have no other source of revenue.

The note payable of $167,000 at June 30, 2007 relates to the purchase of certain fixed assets. The purchase of these fixed assets was pursuant to a development, manufacturing and supply agreement that Hercon entered into with a client company. Payment terms of the note are contingent upon certain performance criteria under the agreement. One such performance criteria applicable to the client company may result in the note being forgiven. On August 20, 2007, the client company and Hercon entered into a letter amendment to the development, manufacturing and supply agreement whereby the $167,000 note was immediately forgiven.

On September 25, 2007, Andy Yurowitz sold his 50% interest in York Realty Leasing LLC at cost to William Robbins, an unrelated third party, making Mr. Robbins the 100% owner of York Realty Leasing LLC. Prior to this sale, Mr. Robbins had owned the remaining 50% of York Realty Leasing LLC.

On December 11, 2007, the Company entered into a new collective bargaining agreement with the R.W.D.S.U. The new agreement is for a three year period ending December 10, 2010 and is on substantially the same terms as the expiring agreement.

On January 4, 2008, Transderm filed a Complaint for Declaratory Relief, Breach of Contract and Monetary Damages against York Realty Leasing LLC (“York”) in the Court of Common Pleas of York County, Pennsylvania (the “Complaint”). The action arises out of York’s various correspondences to Transderm alleging that it is in breach of and default under the lease between the parties dated December 7, 2004 for failure to pay rent as provided in the lease. In the Complaint, the Company is seeking, among other things, a declaratory judgment to the effect that the lease is in full force and effect, that the Company is not in default under the lease and that Transderm is owed an amount on account with York which York has refused to credit to Transderm. On January 23, 2008, the Company filed an amended complaint in this matter seeking to clarify certain facts but otherwise requesting the same relief. York did not file a timely answer to the Company’s complaint and, upon further notice to York, the Court entered a default judgment in favor of the Company on February 26, 2008. A hearing in this matter was held on April 25, 2008 whereby the Court ordered that the lease is in full force and effect, that the Company is not in default under the lease and that Transderm is entitled to a rental credit of $57,200.

On February 25, 2008, Andy Yurowitz, a director and the former chief executive of Health-Chem and each of its subsidiaries, served each of Health-Chem and Hercon with a summons without complaint which was filed in The Supreme Court of the State of New York, Kings County on February 7, 2008. The summons also indicated that Andrew Levinson and Manfred Mayerfeld, members of the Boards of Health-Chem and Hercon, will be named in this action. The summons requires that each party file a notice of appearance in the action within a specified time after being served. The summons states that the nature of the action and the relief sought is defendant’s breach of contract and failure to pay wages. Until the Company is served with and reviews the complaint with counsel, it is unable to comment upon the allegations or any potential defenses.

Item 2. Management's Discussion and Analysis or Plan of Operation.

This Management's Discussion or Plan of Operation section contains a number of forward-looking statements, all of which are based on current expectations. Actual results may differ materially from the anticipated results discussed herein.

The Company

Transderm Laboratories Corporation ("Transderm") manufactures nitroglycerin transdermal patches and conducts research and development activities for third parties on a contract basis. Transderm conducts the majority of its business and all of its manufacturing operations through Hercon Laboratories Corporation ("Hercon"), in which it owns 98.5% of the outstanding shares of capital stock (Transderm and Hercon may sometimes be referred to collectively as "we", "us", or the "Company"). Transderm is a 90%-owned subsidiary of Health-Chem Corporation ("Health-Chem" which, together with Transderm, Hercon and Health-Chem's other subsidiaries, may be referred to as the "Group").

Until April 25, 2007, the Company had manufactured and sold drug-in-adhesive transdermal nitroglycerin patch products (the "Hercon Products") under the terms of a license agreement between Key Pharmaceuticals, Inc., a division of Schering Plough ("Key"), and Hercon dated March 13, 2000 (the "License Agreement"). By letter dated April 26, 2007, Key notified Hercon that it terminated the License Agreement based on Hercon's failure to pay royalties on sales of the Hercon Products or otherwise account to Key for sales of the Hercon Products. On April 27, 2007, Key served Hercon with a complaint filed in the United States District Court, District of New Jersey (the "Court"), demanding payment of all royalties due under the License Agreement (the "Action"). Hercon did not have the means to repay the accrued royalties under the License Agreement. The products covered by the Key License represented the Company's only products and, upon termination of the License Agreement, left it without any other meaningful source of continuing revenue.

On May 23, 2007, Key, on the one hand, and Hercon and McTevia & Associates, LLC, as the purported trustee of the Company's assets ("Trustee") pursuant to a so-called trust mortgage under which the Company purportedly granted to McTevia & Associates a security interest in all of its real and personal property, on the other hand, executed a Final Judgment On Consent wherein, among other things, (i) the parties stipulated that the amount of royalties owed to Key under the License Agreement exceeded $8 million (though the parties settled on that amount), (ii) the parties outlined a financial settlement with respect to royalties owed to Key, (iii) the Company was required to pay Key the sum of $500,000 (for which it would be credited the amount of $1 million and which would reduce the aggregate royalties owed to Key by $1 million to $7 million) and (iv) Key granted the Company a limited right under the License Agreement to manufacture and sell the Hercon Products through August 16, 2007, as more fully described in Transderm's quarterly report on Form 10-Q for the three months ended March 31, 2007 (the "Consent Judgment"). The Consent Judgment was predicated on Hercon's intention to wind down and cease business operations by August 16, 2007 while remaining operational until such date in order to maximize the value of its assets and inventory for the benefit of its creditors.

Over the ensuing months, Key periodically extended the Company's limited right to manufacture and sell the Hercon Products under the Consent Judgment, in one case requiring the payment of $150,000 to extend such right to November 16, 2007.

On November 12, 2007, the Group terminated the Trustee and began to negotiate directly with Key.

On April 21, 2008, after many months of negotiations, Key and Hercon entered into a Settlement Agreement (“Settlement Agreement”) with respect to settling outstanding controversies between the parties under the terms of the Consent Judgment, which will allow the Company to continue manufacturing and selling the Hercon Products indefinitely, subject to satisfying certain continuing financial obligations.

Under the Settlement Agreement, a copy of which was annexed as an exhibit to Transderm’s Current Report on Form 8-K filed with the SEC on April 29, 2008, the parties agreed that, among other material terms:

- The Company would pay to Key an aggregate of $1,425,000, of which the Company paid Key $1,000,000 upon the execution of the Settlement Agreement and agreed to pay the balance of $425,000 in seven equal installments of $60,714.29, payable as follows: by July 21, 2008, October 21, 2008, January 21, 2009, April 21, 2009, July 21, 2009, October 21, 2009 and December 21, 2009. The payments aggregating $425,000 will be applied to the satisfaction of all royalties that may become due under the License Agreement from the date of the Settlement Agreement through the termination of the License Agreement.

- The License Agreement will continue in effect until it expires on February 16, 2010 as modified by the Settlement Agreement, in that all future royalties under the License Agreement would be satisfied by the additional payments to be made in the future totaling $425,000, as described above, and that the Company would no longer be required to account to Key for royalties going forward;

- The Consent Judgment, including Key’s right to receive past due royalty payments thereunder (aggregating $6,850,000 as of the date of the Settlement Agreement), would remain in full force and effect until Key received payment of all amounts owed under the Settlement Agreement;

- All parties to the Settlement Agreement and their respective affiliates were released from all claims that were or could have been asserted in the action brought by Key, that were subsumed within Key’s lawsuit against Hercon or in relation to the Consent Judgment or otherwise, except that if Key was required to return any of the monies paid to it under a bankruptcy or other disgorgement proceeding, which, if not cured by the Company, then Key’s release would be deemed void and Key would have a right to pursue the full amount due to it under the Consent Judgment, as well as any other course of action it would be entitled to take;

- The Company would have the right to cure any breach of the Settlement Agreement within 25 days after written notice requesting a cure.

- Andrew Levinson and Manfred Mayerfeld, directors of each of the constituent corporations of the Company, agreed that they would be jointly and severally liable to Key, if within 90 days of the date that Key received the first payment, a proceeding were commenced against Hercon or Key and Key was thereafter ordered in such proceeding, pursuant to a final, non-appealable order, to return or disgorge all or any portion of the initial $1,000,000 payment under the Settlement Agreement. The amount for which either or both would be liable would be the lesser of the amount ordered to be returned or disgorged or the amount of that initial payment. Any obligations of Mr. Levinson or Mr. Mayerfeld would be deemed to be extinguished if within 90 days of the date Key received the first payment, it did not receive notice of an action, potential action or other proceeding requiring it to return or disgorge such payment or any portion thereof and such action or proceeding is not commenced. At a meeting of the Board of Directors of the Company (the “Board”) held on April 16, 2008, at which the Board approved the terms of settlement described above, the Board agreed to defer consideration of appropriate collateral to be provided to Messrs. Levinson and Mayerfeld for their guarantee and appropriate compensation to them therefor.

In order to satisfy the initial payment to Key under the Settlement Agreement, Transderm borrowed $1 million from its parent, Health-Chem Corporation, which owns 90% of Transderm's outstanding common stock.

The foregoing description of the contents of the Settlement Agreement is qualified by the full text of the agreement on file with the SEC.

As of June 30, 2007, the Company had total liabilities of approximately $41.5 million, which includes (i) $31.4 million owed to Health-Chem, (ii) $7.1 million of royalties owed to Key under the Key License and (iii) other current trade payables and miscellaneous liabilities aggregating $3.0 million. Also, at June 30, 2007, the Company had a working capital deficiency of $27.3 million and cash and other current assets of $2.2 million. The notes to our audited consolidated financial statements for the year ended December 31, 2006 and the auditor's report accompanying said financial statements indicate that these liabilities and the Company's working capital deficiency raise substantial doubt about our ability to continue as a going concern.

Results of Operations.

Six months ended June 30, 2007 versus the six months ended June 30, 2006

We incurred a net loss during the six months ended June 30, 2007 of $2,240,000 as compared to a net loss of $1,167,000 for the same period in 2006. The increase in net loss was attributable primarily to a decline in product sales and to additional selling, general and administrative expenses, as described in the ensuing paragraphs.

For the six months ended June 30, 2007, product sales decreased by approximately 23% from the corresponding 2006 period from $2,919,000 to $2,254,000, which, in each case, consisted exclusively of sales of transdermal nitroglycerin patches. Management attributes the decrease to a 61% decline in product sales to one of our largest customers and at a lower average net selling price.

Product development revenue for the six months ended June 30, 2007 was $327,000, consisting of revenues generated from research and development projects we are undertaking for three customers. Product development revenue for the same period in 2006 was $92,000, consisting of revenues from two research and development projects. The $235,000 increase is due to the timing of milestone payments received associated with the various projects.

Other income for the six months ended June 30, 2007 was $408,000. This amount consists of income of $500,000 resulting from the forgiveness of debt under the Consent Judgment, as more fully explained below, which partially is offset by a loss of $92,000 related to the write-off of uncompleted construction. The Company did not report any other income for the same period in 2006. The $500,000 represents forgiveness of debt in that a $500,000 payment made to Key under the terms of the Consent Judgment resulted in a reduction of total royalties owed to Key under the License Agreement by $1,000,000.

Gross profit decreased by $948,000, or 122%, leading to a gross loss of $168,000 for the six months ended June 30, 2007 as compared to a gross profit of $780,000 for the same period in 2006. Gross profit as a percent of total revenues decreased from 26% during the six months ended June 30, 2006 to a negative 7% during the same period in 2007. The decrease in gross profit was due primarily to decreased sales volumes of lower margin products and to additional royalty expense of $332,000 recorded pursuant to the Consent Judgment.

Selling, general and administrative expenses increased by $522,000 for the six months ended June 30, 2007 as compared to the corresponding period in 2006. The increase is due primarily to increases in professional/consulting fees, legal fees and corporate services expenses allocated from Health-Chem of $289,000, $136,000 and $252,000, respectively, partially offset by decreases in wages and commission expense of $98,000 and $40,000, respectively. A significant portion of the legal and professional/consulting fees incurred during 2007 were attributable to the Key royalty negotiations and establishing the Trust Mortgage.

Research and development expenses decreased by $42,000 to $216,000 for the six months ended June 30, 2007 as compared to the corresponding period in 2006. The decrease is due primarily to decreases in wages, lab supplies and repairs and maintenance of $13,000, $14,000 and $16,000, respectively.

Net interest expense increased by $53,000, or 10%, to $564,000 for the six months ended June 30, 2007 as compared to $511,000 for the same period in 2006. The increase consists of a $67,000 increase in interest expense, partially offset by a $14,000 increase in interest income. The interest expense increase is due to $62,000 of additional interest related to higher average outstanding balances on borrowings from Health-Chem and to $5,000 of additional interest due to higher interest rates associated with the variable rate mortgage. The interest income increase is due primarily to the Company adopting an investment policy in April 2006 whereby all excess cash is automatically invested in interest-bearing instruments.

Three months ended June 30, 2007 versus the three months ended June 30, 2006

We incurred a net loss during the three months ended June 30, 2007 of $1,470,000 as compared to a net loss of $584,000 for the same period in 2006. The increase in net loss was attributable primarily to a decline in product sales and to additional selling, general and administrative expenses, as described in the ensuing paragraphs.

For the three months ended June 30, 2007, product sales decreased by approximately 15% from the corresponding 2006 period from $1,300,000 to $1,105,000, which, in each case, consisted exclusively of sales of transdermal nitroglycerin patches. Management attributes the decrease to a lower average net selling price.

Product development revenue for the three months ended June 30, 2007 was $59,000, consisting of revenues generated from research and development projects we are undertaking for one customer. Product development revenue for the same period in 2006 was $87,000, consisting of revenues from two research and development projects. The $28,000 decrease is due to the timing of milestone payments received associated with the various projects.

Other income for the three months ended June 30, 2007 was $408,000. This amount consists of income of $500,000 resulting from the forgiveness of debt under the Consent Judgment, as more fully explained below, which partially is offset by a loss of $92,000 related to the write-off of uncompleted construction. The Company did not report any other income for the same period in 2006. The $500,000 represents forgiveness of debt in that a $500,000 payment made to Key under the terms of the Consent Judgment resulted in a reduction of total royalties owed to Key under the License Agreement by $1,000,000.

Gross profit decreased by $759,000, or 206%, leading to a gross loss of $391,000 for the three months ended June 30, 2007 as compared to a gross profit of $368,000 for the same period in 2006. Gross profit as a percent of total revenues decreased from 27% during the three months ended June 30, 2006 to a negative 34% during the same period in 2007. The decrease in gross profit was due primarily to increased sales volumes of lower margin products and to additional royalty expense of $332,000 recorded pursuant to the Consent Judgment.

Selling, general and administrative expenses increased by $541,000 for the three months ended June 30, 2007 as compared to the corresponding period in 2006. The increase is due primarily to increases in professional/consulting fees, legal fees and corporate services expenses allocated from Health-Chem of $291,000, $136,000 and $205,000, respectively, partially offset by decreases in wages and commission expense of $59,000 and $16,000, respectively. A significant portion of the legal and professional/consulting fees incurred during 2007 were attributable to the Key royalty negotiations and establishing the Trust Mortgage.

Research and development expenses decreased by $40,000 for the three months ended June 30, 2007 as compared to the corresponding period in 2006. The decrease is due primarily to decreases in wages, repairs and maintenance, lab supplies and clinical materials/testing of $3,000, $16,000, $13,000 and $7,000, respectively.

Net interest expense increased by $34,000, or 13%, to $287,000 for the three months ended June 30, 2007 as compared to $253,000 for the same period in 2006. The increase consists of a $33,000 increase in interest expense and a $1,000 decrease in interest income. The interest expense increase is due to $32,000 of additional interest related to higher average outstanding balances on borrowings from Health-Chem and to $1,000 of additional interest due to higher interest rates associated with the variable rate mortgage. The interest income decrease is due primarily to lower interest rates associated with the mortgage escrow deposit.

Liquidity and Capital Resources.

At June 30, 2007, the Company had total current assets of $2.2 million, including $135,000 in cash, and a working capital deficiency of $27.3 million, the calculation of which includes current liabilities owed to Health-Chem aggregating $21.6 million. Without giving effect to current liabilities in favor of Health-Chem, we had a working capital deficiency of $5.7 million. Our total stockholders' deficiency was $37.8 million at June 30, 2007, compared to $35.6 million at December 31, 2006. As of June 30, 2007, we had an accumulated deficit of approximately $37,884,000. Our principal sources of liquidity have been cash provided by loans from Health-Chem and cash generated by operations. Our principal uses of cash have been for working capital, royalty fees and the payment of various professional, consulting and legal fees.

Our working capital deficiency increased by $1,359,000 from December 31, 2006 to June 30, 2007 due to a decrease of $1,800,000 in current assets, partially offset by a decrease of $441,000 in current liabilities. The current assets decrease consists of decreases in cash, accounts receivable and inventory of $1,010,000, $820,000 and $100,000, respectively, partially offset by an increase in other current assets of $130,000. The current liabilities decrease consists primarily of decreases in accounts payable, royalties payable and other liabilities of $62,000, $249,000 and $429,000, respectively, partially offset by an increase in preferred stock dividends payable of $298,000. The decrease in accounts receivable resulted from a decrease in sales in the second quarter of 2007 as compared to the fourth quarter of 2006 and also reflects the timing of customer payments. The decrease in inventory reflects lower transdermal nitroglycerin product sales and the timing of raw material purchases. The increase in other current assets is due primarily to retainers paid to various professional organizations. The royalties payable decrease is attributable to the Company commencing royalty payments to Key in May 2007. The other liabilities decrease is due primarily to decreases in accrued chargebacks, rebates and allowances, and audit fees. The increase in preferred stock dividends payable is due to legally available funds not being available to make the required dividend payment.

Cash used for operating activities for the six months ended June 30, 2007 was $1,640,000, as compared to cash provided by operating activities of $222,000 for the same period in 2006. The decrease is due primarily to a $2,240,000 net loss in 2007 as compared to a $1,167,000 net loss in 2006 and to decreasing accounts receivable, inventory, accounts payable, royalties payable and other liabilities of $820,000, $100,000, $62,000, $249,000 and $429,000, respectively, and increasing other current assets of $130,000 in 2007 as compared to decreasing accounts receivable, other current assets, accounts payable and other liabilities of $2,045,000, $23,000, $125,000 and $1,266,000, respectively, and increasing inventory and royalties payable of $276,000 and $537,000, respectively, in 2006. The Company had no investing activities for the six months ended June 30, 2007. Investing activities for the six months ended June 30, 2006 used cash of $105,000, consisting of additions made to property, plant and equipment. Financing activities for the six months ended June 30, 2007 provided $630,000 of cash as compared to the same period in 2006 which provided $243,000 of cash.

The Company's current financial and operating condition raises significant doubt about our ability to continue as a going concern. We anticipate that, given our historical operating results, we may not generate sufficient revenues from product sales to satisfy our ongoing obligations under the Settlement Agreement until the amount due is paid in full. We are paying our current expenses, obligations and liabilities to third parties as they become due from cash generated from sales and from cash borrowed from Health-Chem, which received a $1.85 million payment from the State of Pennsylvania in May 2007, representing amounts held by such agency on Health-Chem's behalf. We would like to expand our operations to add other transdermal products and enter into agreements with third parties to conduct research and development activities on their behalf, though we cannot say with certainty whether we will be presented with any such opportunities or if we will have the capital resources to pursue such activities. We do not have the capital to pursue such opportunities and we cannot be certain that we will have access to capital on acceptable terms, if at all, should an opportunity presents itself. Accordingly, we cannot predict our future capital requirements at this time.

Off-Balance Sheet Arrangements.

We have not entered into any off-balance sheet arrangements.

Critical Accounting Policies.

Our significant accounting policies are described in Note 2 of the Notes to Consolidated Financial Statements of the Company's Annual Report on Form 10-KSB for the year ended December 31, 2006. Included within these policies are certain policies which contain critical accounting estimates and, therefore, have been deemed to be "critical accounting policies." Critical accounting estimates are those which require management to make assumptions about matters that were uncertain at the time the estimate was made and for which the use of different estimates, which reasonably could have been used, or changes in the accounting estimates that are reasonably likely to occur from period to period, could have a material impact on the presentation of our financial condition, changes in financial condition or results of operations.

Inflation.

We believe that our results of operations are not dependent upon moderate changes in inflation rates.

FORWARD-LOOKING STATEMENTS

The Private Securities Litigation Reform Act of 1995 (the Act) provides a safe harbor for forward-looking statements made by or on behalf of our company. From time to time, our representatives and we may make written or verbal forward-looking statements, including statements contained in this report and other company filings with the SEC and in our reports to stockholders. Statements that relate to other than strictly historical facts, such as statements about our plans and strategies, expectations for future financial performance, new and existing products and technologies, and markets for our products are forward-looking statements within the meaning of the Act. Generally, the words "believe," "expect," "intend," "estimate," "anticipate," "will" and other similar expressions identify forward-looking statements. The forward-looking statements are and will be based on our then-current views and assumptions regarding future events and operating performance, and speak only as of their dates. Investors are cautioned that such statements involve risks and uncertainties that could cause actual results to differ materially from historical or anticipated results due to many factors including, but not limited to, our limited revenues, our future capital needs, uncertainty of capital funding, acceptance of our product offerings, the effects of government regulations on our business, competition, and other risks. We undertake no obligation to publicly update or revise any forward-looking statements.

Item 3. Controls and Procedures.

(a) Disclosure Controls and Procedures. Our management, with the participation of our chief executive officer and chief financial officer, has evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of the end of the period covered by this report. Based on such evaluation, our chief executive officer and chief financial officer have concluded that, as of the end of such period, our disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by us in the reports that we file or submit under the Exchange Act.

(b) Internal Control Over Financial Reporting. There have not been any changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II — OTHER INFORMATION

Item 1. Legal Proceedings.

As of the date hereof, the Company is party to three legal proceedings, as follows:

Key: See Part I, Item 2. Management’s Discussion and Analysis or Plan of Operation for a discussion of the action by Key against Hercon in the Federal District Court for the District of New Jersey.

York Realty LLC: On January 4, 2008, Transderm filed a Complaint for Declaratory Relief, Breach of Contract and Monetary Damages against York Realty Leasing, LLC (“York”) in the Court of Common Pleas of York County, Pennsylvania (the “Complaint”). The action arises out of York’s various correspondences to Transderm alleging that it is in breach of and default under the lease between the parties dated December 7, 2004 for failure to pay rent as provided in the lease. In the Complaint, the Company is seeking, among other things, a declaratory judgment to the effect that the lease is in full force and effect, that the Company is not in default under the lease and that Transderm is owed an amount on account with York which York has refused to credit to Transderm. On January 23, 2008, the Company filed an amended complaint in this matter seeking to clarify certain facts but otherwise requesting the same relief. York did not file a timely answer to the Company’s complaint and, upon further notice to York, the Court entered a default judgment in favor of the Company on February 26, 2008. A hearing in this matter was held on April 25, 2008 whereby the Court ordered that the lease is in full force and effect, that the Company is not in default under the lease and that Transderm is entitled to a rental credit of $57,200.

Yurowitz Action: On February 25, 2008, Andy Yurowitz, a director and the former chief executive of Transderm, Hercon and Health-Chem, served each of Health-Chem and Hercon with a summons without complaint which was filed in The Supreme Court of the State of New York, Kings County on February 7, 2008. The summons also indicated that Andrew Levinson and Manfred Mayerfeld, members of the Boards of Health-Chem and Hercon, will be named in this action. The summons requires that each party file a notice of appearance in the action within a specified time after being served.

The summons states that the nature of the action and the relief sought is defendant’s breach of contract and failure to pay wages. Until the Company is served with and reviews the complaint with counsel, it is unable to comment upon the allegations or any potential defenses.

Item 2. Changes in Securities and Small Business Issuer Purchase of Equity Securities.

(a) None.

(b) None.

(c) During the three months ended June 30, 2007, the Company did not issue any securities.

(d) None.

(e) None.

Item 3. Defaults Upon Senior Securities.

On August 31, 1995, Hercon issued to Health-Chem a $7,000,000, 9% Subordinated Promissory Note in exchange for the then outstanding borrowings from affiliates. The Company has been required to make semi-annual interest payments each March and September on this note. The principal amount of $7,000,000 was due on March 31, 2002. In March, 2002 the Company defaulted on its obligation to repay the principal amount of $7,000,000. Interest on the principal amount of this promissory note, which accrues at the rate of $630,000 per annum, is transferred semi-annually each March and September into the Group’s intercompany account.

Item 4. Submission of Matters to a Vote of Security Holders.

None.

Item 5. Other Information.

(a) Cancellation of Note Payable. On August 20, 2007, a note payable by Hercon in the amount of $167,000 at June 30, 2007 was cancelled under the terms of an agreement between Hercon and a client that had retained Hercon to undertake research and development activities on its behalf. The agreement provided that in the event that the client did not file certain documents with the United States Food and Drug Administration by May 30, 2006, the note was cancelable by Hercon and all amounts due thereunder would be forgiven by the note holder.

(b) Termination of Andy Yurowitz as Chief Executive Officer and President. On May 14, 2007, James McTevia, in his capacity as Chief Restructuring Officer of the Company, terminated Andy Yurowitz as a paid employee of Transderm, Hercon and Health-Chem. Mr. Yurowitz's status as an officer of each of these companies was not affected by such termination. On November 22, 2007, the Board ratified the prior termination of Andy Yurowitz as a paid employee and terminated him as the Chief Executive Officer and President, for cause. Mr. Yurowitz continues to serve as a member of the board of Transderm, Hercon and Health-Chem.

(c) Appointment of Acting Chief Executive Officer. On November 22, 2007, the board of directors appointed Ron Burghauser, the chief financial officer of Transderm and Hercon, as the acting chief executive officer of each company.

Item 6. Exhibits.

(a) Exhibits.

Exhibit No.	Description
10.1	Consent Judgment dated May 23, 2007, by the United States District Court, District of New Jersey entered a Final Judgment On Consent between Key Pharmaceuticals, Inc. and Hercon Laboratories Corporation.
31.1	Certification of Principal Executive Officer and Principal Financial Officer pursuant to Rule 13a-14 and Rule 15d 14(a), promulgated under the Securities and Exchange Act of 1934, as Amended.
32.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

In accordance with 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.

TRANSDERM LABORATORIES CORPORATION

Name and Capacity	Date
/s/ Ronald J. Burghauser By: Ronald J. Burghauser Acting Chief Operating Officer, Chief Financial Officer, Treasurer and Secretary (Principal Financial Officer) (Principal Accounting Officer)	June 3, 2008