SERVICE CORPORATION INTERNATIONAL
Form 4
November 18, 2009

FORM 4

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP OF SECURITIES

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

OMB APPROVAL

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Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. *See* Instruction 1(b).

(Print or Type Responses)

1. Name and Address of Reporting Person *
RYAN THOMAS L

(Last) (First) (Middle)

1929 ALLEN PARKWAY

(Street)

HOUSTON, TX 77019

(City) (State) (Zip)

2. Issuer Name **and** Ticker or Trading Symbol
SERVICE CORPORATION INTERNATIONAL [SCI]

3. Date of Earliest Transaction (Month/Day/Year)
11/16/2009

4. If Amendment, Date Original Filed(Month/Day/Year)

5. Relationship of Reporting Person(s) to Issuer

(Check all applicable)

__X__ Director _____ 10% Owner
__X__ Officer (give title below) _____ Other (specify below)
President,Chief Executive Off.

6. Individual or Joint/Group Filing(Check Applicable Line)
_X_ Form filed by One Reporting Person
___ Form filed by More than One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1.Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	Amount	(A) or (D)	Price			
Common Stock	11/16/2009		M		100,000	A	$ 5.065	859,307	D	
Common Stock	11/16/2009		S		100,000	D	$ 7.5336 (1)	759,307	D	
Common Stock								21,977	I	By 401(k) plan

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

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Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned
(*e.g.*, puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Underlying Securities (Instr. 3 and 4)	
				Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares
Employee Stock Option (right to buy)	$ 5.065	11/16/2009		M			100,000	02/13/2005	02/13/2010	Common Stock	100,0

Reporting Owners

Reporting Owner Name / Address	Relationships			
	Director	10% Owner	Officer	Other
RYAN THOMAS L 1929 ALLEN PARKWAY HOUSTON, TX 77019	X		President,Chief Executive Off.	

Signatures

Thomas L. Ryan	11/17/2009
**Signature of Reporting Person	Date

Explanation of Responses:

***** If the form is filed by more than one reporting person, *see* Instruction 4(b)(v).

****** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

(1) The reported sales were made pursuant to a Rule 10b5-1 trading plan adopted by the reporting person on September 10, 2009. The shares were sold in multiple transactions at prices ranging from $7.44 to $7.69 per share on November 16, 2009. The $7.5336 sale price reported above is the weighted average sales price on November 16, 2009. The reporting person undertakes to provide upon request by the Commission staff, the issuer or a security holder of the issuer, full information regarding the number of shares sold at each separate price.

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, *see* Instruction 6 for procedure.
Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB number. believe that the following accounting policies require the application of significant judgments and estimates.

Revenue Recognition

Revenue is recognized in accordance with ASC Topic 605. Four basic criteria must be met before revenue can be recognized: (i) persuasive evidence of an arrangement exists; (ii) delivery has occurred or services have been rendered; (iii) the fee is fixed and determinable; and (iv) collectability is reasonably assured.

We recognize revenue related to product sales when delivery is confirmed by its external logistics provider and the other criteria of ASC Topic 605 are met. Product revenue is recorded net of returns and allowances. All costs and duties relating to delivery are absorbed by Nephros. All shipments are currently received directly by our customers.

Stock-Based Compensation

We account for stock-based compensation in accordance with ASC 718 by recognizing the fair value of stock-based compensation in net income. The fair value of our stock option awards are estimated using a Black-Scholes option valuation model. This model requires the input of highly subjective assumptions and elections including expected stock price volatility and the estimated life of each award. In addition, the calculation of compensation costs requires that we estimate the number of awards that will be forfeited during the vesting period. The fair value of stock-based awards is amortized over the vesting period of the award. For stock awards that vest based on performance conditions (e.g. achievement of certain milestones), expense is recognized when it is probable that the condition will be met.

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Accounts Receivable

We provide credit terms to our customers in connection with purchases of our products. We periodically review customer account activity in order to assess the adequacy of the allowances provided for potential collection issues and returns. Factors considered include economic conditions, each customer s payment and return history and credit worthiness. Adjustments, if any, are made to reserve balances following the completion of these reviews to reflect our best estimate of potential losses.

Inventory Reserves

Our inventory reserve requirements are based on factors including the products expiration date and estimates for the future sales of the product. If estimated sales levels do not materialize, we will make adjustments to its assumptions for inventory reserve requirements.

Accrued Expenses

We are required to estimate accrued expenses as part of our process of preparing financial statements. This process involves identifying services which have been performed on our behalf, and the level of service performed and the associated cost incurred for such service as of each balance sheet date in our financial statements. Examples of areas in which subjective judgments may be required include costs associated with services provided by contract organizations for the preclinical development of our products, the manufacturing of clinical materials, and clinical trials, as well as legal and accounting services provided by professional organizations. In connection with such service fees, our estimates are most affected by our understanding of the status and timing of services provided relative to the actual levels of services incurred by such service providers. The majority of our service providers invoice us monthly in arrears for services performed. In the event that we do not identify certain costs, which have begun to be incurred, or we under- or over-estimate the level of services performed or the costs of such services, our reported expenses for such period would be too low or too high. The date on which certain services commence, the level of services performed on or before a given date and the cost of such services are often determined based on subjective judgments. We make these judgments based upon the facts and circumstances known to us in accordance with generally accepted accounting principles.

Results of Operations

Fluctuations in Operating Results

Our results of operations have fluctuated significantly from period to period in the past and are likely to continue to do so in the future. We anticipate that our annual results of operations will be impacted for the foreseeable future by several factors including the progress and timing of expenditures related to our research and development efforts, marketing expenses related to product launches, timing of regulatory approval of our various products and market acceptance of our products. Due to these fluctuations, we believe that the period to period comparisons of our operating results are not a good indication of our future performance.

The Fiscal Year Ended December 31, 2009 Compared to the Fiscal Year Ended December 31, 2008

Product Revenues

Total product revenues for the year ended December 31, 2009 were $2,661,000 compared to $1,473,000 for the year ended December 31, 2008. The $1,188,000, or 81%, increase is primarily due to $1,093,000 related to revenue generated from the Office of Naval Research project in the United States. The revenue derived from this project was $1,093,000 for the twelve months ended December 31, 2009 compared to $196,000 for the same period in 2008, which was the project s initial period beginning in January 2008. Sales of the OLpur MD190 and MD220 Dialyzers in Europe were $1,265,000 for the twelve months ended December 31, 2009 compared to $1,228,000 for the same period in 2008. This $37,000 or 3% increase in revenue was impacted by the adverse currency translation of the Euro to the U.S. dollar. Units sold were 47,532 for the twelve months ended December 31, 2009 compared to 44,623 units for the same period in 2008, a 6.5% increase. Although the sales price of these units, which is in Euro, remained constant approximately $53,000 was lost due to currency translation. In addition, revenues in the United States from sales of the Dual Stage Ultrafilter (the DSU) water filter were $303,000 for the twelve months ended December 31, 2009 compared to $49,000 for the same period in 2008. The DSU represents a new and complementary product line introduced in 2008.

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Cost of Goods Sold

Cost of goods sold was $1,744,000 for the year ended December 31, 2009 compared to $1,064,000 for the year ended December 31, 2008. The $680,000, or 64%, increase is primarily due to costs related to the Office of Naval Research project in the United States. The cost of goods sold related to the Office of Naval Research project was $692,000 for the twelve months ended December 31, 2009 compared to $141,000 for the same period in 2008, an increase of $551,000. The increased cost is correlated to the higher revenue recognized from this project for the year ended December 31, 2009 compared to the same period in 2008. Cost of goods sold related to the OLpur MD190 and MD220 Dialyzers sold in Europe for the year ended December 31, 2009 was $969,000 an increase of $46,000, or 5%, over the comparable period in 2008. This increase was due primarily to higher sales volume. Units sold were 47,532 for the twelve months ended December 31, 2009 compared to 44,623 units for the same period in 2008, a 6.5% increase. Cost of goods sold related to the DSU water filters sold in the United States were $83,000 for the year ended December 31, 2009. The DSU represents a new and complementary product line introduced in 2008 and there were no cost of goods sold incurred for the year ended December 31, 2008.

Research and Development

Research and development expenses were $280,000 for the year ended December 31, 2009 compared to $1,977,000 for the year ended December 31, 2008, a decrease of $1,697,000 or 86%. This decrease is related to the fact that a clinical trial was conducted in 2008 and there was no clinical trial conducted during 2009. Clinical trial expenses decreased by approximately $964,000 during the twelve months ended December 31, 2009 compared to the same period in 2008. Related reductions in personnel and lab testing resulted in reduced expenses of $491,000 and $226,000 respectively during the twelve months ended December 31, 2009 compared to the same period in 2008. A reduction in travel expenses in the amount of $23,000 was offset by an increase of $13,000 in development expenses related to the DSU water filter during the twelve months ended December 31, 2009 compared to the same period in 2008.

Depreciation and Amortization Expense

Depreciation expense was $231,000, for the year ended December 31, 2009 compared to $447,000 for the year ended December 31, 2008, a decrease of $216,000, or 48.3%. An additional $59,000 of depreciation was recorded in 2008 related to furniture and fixtures and tooling to reflect the assessed utility of these assets as of December 31, 2008.

Selling, General and Administrative Expenses

Selling, general and administrative expenses were $2,812,000 for the year ended December 31, 2009 compared to $4,702,000 for the year ended December 31, 2008, a decrease of $1,890,000 or 40%. A reduction in personnel and related expenses resulted in a decrease of $1,072,000 for the twelve months ended December 31, 2009 compared to the same period in 2008. Reductions of $246,000 in legal expenses, $232,000 in marketing expenses, $186,000 in recruiting expenses, $70,000 in insurance expenses and $85,000 in facility expenses for the twelve months ended December 31, 2009 compared to the same period in 2008 were also achieved. The legal expense reduction was due to less activity and transition to a new law firm in 2009. Marketing activities related to trade shows were curtailed in 2009. Recruiting fees were incurred for four hires in 2008 and none in 2009. The reduction in facility expenses resulted from both the Ireland and U.S. offices moving to less expensive locations for 2009.

Interest Income

Interest income was $9,000 for the year ended December 31, 2009 compared to $199,000 for the year ended December 31, 2008. The decrease of $190,000, or 95.5%, reflects the impact of having less cash on hand in 2009 compared to 2008 and therefore, fewer investments to generate interest income.

Interest Expense

We incurred approximately $2,000 of interest expense for the year ended December 31, 2009. This interest relates primarily to financing of premiums for product liability insurance. No interest expense was incurred during 2008. We had no outstanding debt during 2009 or 2008.

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Impairment of Auction Rate Securities and Gain on sale of investments

During the fiscal year 2008, we had investments in auction rate securities (ARS) which are long-term debt instruments with interest rates reset through periodic short-term auctions. If there are insufficient buyers when such a periodic auction is held, then the auction fails and the holders of the ARS are unable to liquidate their investment through such auction. With the liquidity issues experienced in global credit and capital markets, the ARS held by us had experienced multiple failed auctions since February 2008, and as a result, we did not consider these affected ARS liquid in the first quarter of 2008. Accordingly, while we had classified its ARS as current assets as of January 1, 2008, we reclassified them as noncurrent assets at March 31, 2008.

Based upon an analysis of other-than-temporary impairment factors, we wrote down ARS with an original par value of $4,400,000 to an estimated fair value of $4,286,000 as of March 31, 2008. We reviewed impairments associated with the above in accordance with ASC Topic 320 to determine the classification of the impairment as temporary or other-than-temporary. We determined the ARS classification to be other-than-temporary, and charged an impairment loss of $114,000 on the ARS to its results of operations for the three months ended March 31, 2008 and twelve months ended December 31, 2008.

During the three months ended June 30, 2008, $300,000 of principal on our ARS had been paid back by the debtor, resulting in our investment in ARS having decreased from $4,400,000 to $4,100,000 (par value) at June 30, 2008. The net book value of our ARS at June 30, 2008 was $3,986,000, due to the approximate $114,000 impairment recorded at March 31, 2008. On July 22, 2008 we sold our ARS to a third party at 100% of par value, for proceeds of $4,100,000. We reclassified the ARS from Available-for-Sale to Trading Securities due to the sale of the investments in July 2008.

In accordance with ASC Topic 320, the ARS, classified as Trading Securities, were valued at their fair value of $4,100,000 at June 30, 2008. The adjustment of the investment s carrying value from $3,986,000 net book value to $4,100,000 fair value resulted in an Unrealized Holding Gain of $114,000 which is included in our Statement of Operations for the three and six months ended June 30, 2008.

We subsequently reversed the Unrealized Holding Gain and recorded in the results of operations for the twelve months ended December 31, 2008, a Realized Gain on Sale of Investments of $114,000 in July 2008 due to the sale transaction being executed.

We had no investments in Auction Rate Securities during the year ended December 31, 2009.

Other Income

Other income in the amount of approximately $373,000 and $181,000 for the years ended December 31, 2009 and December 31, 2008, respectively, resulted primarily from receipt of New York State Qualified Emerging Technology Company (QETC) tax refunds in each of these periods. Tax credits for the years 2006 and 2007 were received and recognized during the year ended December 31, 2009. The tax credit for the year 2005 was received and recognized during the year ended December 31, 2008.

Nine Months Ended September 30, 2010 Compared to the Nine Months Ended September 30, 2009

Revenues

Total revenues for the nine months ended September 30, 2010 were approximately $2,421,000 compared to approximately $1,869,000 for the nine months ended September 30, 2009. Total revenues increased approximately $552,000. The increase of approximately 30% is due to increased revenue of approximately $260,000 in sales of our DSU in the United States for the nine months ended September 30, 2010 over the same period in 2009. Approximately $73,000 of the increased DSU sales was related to the development agreement with STERIS Corporation, of which approximately $33,000 is related to the recognition of revenue previously deferred and the remaining $40,000 is related to the achievement of a milestone during the three months ended September 30, 2010. Revenue from sales of our MD filters in our Target European Market was approximately $324,000 higher for the nine months ended September 30, 2010 compared to the same period in 2009. Approximately $369,000 of the European revenue increase was due to more units sold, offset partially by $45,000 in losses due to foreign currency exchange rate fluctuation. Unit sales in Europe increased approximately 42% for the nine months ended September 30, 2010 compared to the same period in

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2009. Partially offsetting the increases above was a decrease in net product billings of approximately $32,000 related to our contract with the Office of U.S. Naval Research during the nine months ended September 30, 2010 compared to the nine months ended September 30, 2009.

Cost of Goods Sold

Cost of goods sold was approximately $1,446,000 for the nine months ended September 30, 2010 compared to approximately $1,251,000 for the nine months ended September 30, 2009. The increase of $195,000 or 16% is due to increased costs of approximately $110,000 related to increased sales of our DSU in the United States for the nine months ended September 30, 2010 over the same period in 2009. Costs related to revenue from sales of our MD filters in our Target European Market was approximately $208,000 higher for the nine months ended September 30, 2010 compared to the same period in 2009. Costs related to the contract with the Office of U.S. Naval Research were approximately $123,000 lower for the nine months ended September 30, 2010 compared to the same period in 2009 due to the use of a subcontractor rather than personnel.

Research and Development

Research and development expenses were approximately $259,000 for the nine months ended September 30, 2010 compared to approximately $212,000 for the nine months ended September 30, 2009, an increase of $47,000 or 22%. Approximately $44,000 of the increase was wages primarily due to personnel working on research projects other than the contract with the Office of U.S. Naval Research. The remaining $3,000 increase is due to increased spending on testing materials during the nine months ended September 30, 2010 compared to the same period in 2009.

Depreciation Expense

Depreciation expense was approximately $98,000 for the nine months ended September 30, 2010 compared to approximately $190,000 for the nine months ended September 30, 2009, a decrease of 48%. The decrease of approximately $92,000 is primarily due to several assets having been fully depreciated as of year end 2009 resulting in no depreciation expense for those assets during the nine months ended September 30, 2010. There were no disposals of assets during the nine months ended September 30, 2010.

Selling, General and Administrative Expenses

Selling, general and administrative expenses were approximately $1,903,000 for the nine months ended September 30, 2010 compared to approximately $2,093,000 for the nine months ended September 30, 2009, a decrease of $190,000 or 9%. The decrease is primarily due to a decrease in personnel related expenses of approximately $224,000 during the nine months ended September 30, 2010 compared to the nine months ended September 30, 2009. This decrease was partially offset by increased legal costs of approximately $34,000 during the nine months ended September 30, 2010 compared to the nine months ended September 30, 2009.

Interest Income

Interest income was approximately $1,000 for the nine months ended September 30, 2010 compared to approximately $8,000 for the nine months ended September 30, 2009. The decrease of approximately $7,000 or 88% is due to the decrease in investments held during the nine months ended September 30, 2010 compared to the nine months ended September 30, 2009.

Interest Expense

There was no interest expense for the nine months ended September 30, 2010. We incurred approximately $2,000 of interest expense for the nine months ended September 30, 2009. This interest relates primarily to financing of premiums for product liability insurance.

Other income (expense)

Other income in the amount of approximately $16,000 for the nine months ended September 30, 2010 resulted from the reversal of a prior year s accrual determined to no longer be necessary. Other income in the amount of approximately $328,000 for the nine months ended September 30, 2009 resulted primarily from receipt of New York State Qualified Emerging Technology Company tax refunds for years 2006 and 2007.

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Off-Balance Sheet Arrangements

We did not engage in any off-balance sheet arrangements during the years ended December 31, 2009 and December 31, 2008 or the nine months ended September 30, 2010.

Liquidity and Capital Resources

At September 30, 2010, we had cash and cash equivalents totaling approximately $421,000 and tangible assets of approximately $1,682,000. On September 29, 2010, Lambda Investors loaned us $500,000, which we expect will allow us to operate into March 2011. If we do not complete this rights offering, we expect that we will be forced to wind down our operations. See Going Concern above.

Even if we complete this rights offering, we will need significant additional funding to continue our operations. There can be no assurance that any such funding will be available to us on acceptable terms or at all. Our future liquidity sources and requirements will depend on many factors, including:

the level of stockholder participation in the rights offering
the availability of additional financing, through the sale of equity securities or otherwise, on commercially reasonable terms or at all;
the action of the FDA on our 501(k) application for our hemodiafiltration system.
the market acceptance of our products, and our ability to effectively and efficiently produce and market our products;
the timing and costs associated with obtaining United States regulatory approval or the Conformité Européene, or CE, mark, which demonstrates compliance with the relevant European Union requirements and is a regulatory pre requisite for selling our ESRD therapy products in the European Union and certain other countries that recognize CE marking (for products other than our OLpur MDHDF filter series, for which the CE mark was obtained in July 2003);
the continued progress in and the costs of clinical studies and other research and development programs;
the costs involved in filing and enforcing patent claims and the status of competitive products; and
the cost of litigation, including potential patent litigation and any other actual or threatened litigation.

We expect to put our current capital resources to the following uses:

for the marketing and sales of our products;
to obtain appropriate regulatory approvals and expand our research and development with respect to our ESRD therapy products;
to continue our ESRD therapy product engineering;
to pursue business opportunities with respect to our DSU water-filtration product; and
for working capital purposes.

In response to liquidity issues experienced with our auction rate securities, and in order to facilitate greater liquidity in our short-term investments, on March 27, 2008, our board of directors adopted an Investment, Risk Management and Accounting Policy. Such policy limits the types of instruments or securities in which we may invest our excess funds in the future to: U.S. Treasury Securities; Certificates of Deposit issued by money center banks; Money Funds by money center banks; Repurchase Agreements; and Eurodollar Certificates of Deposit issued by money center banks. This policy provides that our primary objectives for investments shall be the preservation of principal and achieving sufficient liquidity to meet our forecasted cash requirements. In addition, provided that such primary objectives are met, we may seek to achieve the maximum yield available under such constraints.

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Our forecast of the period of time through which our financial resources will be adequate to support our operations is a forward-looking statement that involves risks and uncertainties, and actual results could vary materially. In the event that our plans change, our assumptions change or prove inaccurate, or if our existing cash resources, together with other funding resources including increased sales of our products, otherwise prove to be insufficient to fund our operations and we are unable to obtain additional financing, we will be required to adopt alternatives, such as curtailing our planned activities or ceasing our operations.

At September 30, 2010, we had an accumulated deficit of approximately $91,243,000, and we expect to incur additional losses in the foreseeable future at least until such time, if ever, that we are able to increase product sales or licensing revenue. We have financed our operations since inception primarily through the private placements of equity and debt securities and our initial public offering in September 2004, from licensing revenue received from Asahi Kasei Medical Co., Ltd. (Asahi) in March 2005, a private placement of convertible debenture in June 2006 and a private investment in public equity in September 2007 and a private placement in July 2009.

Net cash used in operating activities was $2,612,000 for the year ended December 31, 2009 compared to $5,725,000 for the year ended December 31, 2008.

During 2009, the net cash used in operating activities was $3,113,000 less than the net cash used in operating activities during 2008. The most significant items contributing to the reduction in cash used in operating cash are highlighted below:

our net loss in 2009 was $2,026,000 compared to $6,337,000 in 2008. This represents an improvement of $4,311,000 in operating cash in 2009. Noncash adjustments to reconcile net loss to net cash used in operating activities were: stock-based compensation was $108,000 and $155,000 in 2009 and 2008 respectively, a reduction of $47,000, depreciation expense was $231,000 and $447,000 in 2009 and 2008 respectively, a reduction of $216,000 and an increase to the inventory reserve of $18,000 in 2009.
during 2009, our accounts receivable, other current assets and other assets increased by $193,000. This compares to a decrease of $236,000 in 2008. This represents a $429,000 use of operating cash in 2009.
during 2009, our inventory decreased by $75,000. This compares to an increase in inventory of $409,000 in 2008. This represents a $484,000 source of operating cash in 2009.
during 2009, accounts payable and accrued expenses decreased by $807,000. This compares to an increase in accounts payable and accrued expenses of $183,000 during 2008. This represents a $990,000 use of operating cash in 2009.

Net cash used by investing activities was $21,000 for the year ended December 31, 2009 compared to $4,599,000 of net cash provided by investing activities for the year ended December 31, 2008. In 2009, $28,000 was used to purchase equipment and $7,000 was provided by the maturity of a short-term investment. In 2008, $4,693,000 was provided due to the maturity of short-term investments. Approximately $97,000 of funds was used to purchase property, plant and equipment and $3,000 was provided by the sale of equipment.

Net cash provided by financing activities was $1,336,000 for the year ended December 31, 2009 resulting from the sale of common stock of $1,251,000 and proceeds from the exercise of stock options of $85,000. There were no financing activities in 2008.

Net cash used in operating activities was approximately $641,000 for the nine months ended September 30, 2010 compared to approximately $1,870,000 for the nine months ended September 30, 2009. The most significant items contributing to this decrease of approximately $1,229,000 cash used in operating activities during the nine months ended September 30, 2010 compared to the nine months ended September 30, 2009 are highlighted below:

during the 2010 period, our net loss decreased by approximately $275,000;
during the 2010 period, we recorded deferred revenue of $67,000, whereas there was no deferred revenue in the 2009 period;

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during the 2010 period, depreciation expense decreased by approximately $92,000;
our accounts receivable decreased by approximately $168,000 during the 2010 period compared to an increase of approximately $114,000 during the 2009 period;
our prepaid expenses and other assets decreased by approximately $67,000 in the 2010 period compared to a decrease of approximately $49,000 in the 2009 period; and
our accounts payable and accrued expenses increased by approximately $129,000 in the aggregate in the 2010 period compared to a decrease of approximately $638,000 in the 2009 period.

Offsetting the above changes are the following items:

during the 2010 period, our stock-based compensation expense increased by approximately $2,000; and
our inventory decreased by approximately $28,000 during the 2010 period compared to a decrease of approximately $118,000 during the 2009 period.

Net cash used in investing activities was approximately $6,000 for the nine months ended September 30, 2010, compared to net cash provided by investing activities of approximately $7,000 for the nine months ended September 30, 2009. Net cash used in investing activities for the nine months ended September 30, 2010 was for the purchase of tooling equipment. Net cash provided by investing activities was approximately $7,000 for the nine months ended September 30, 2009 and resulted from the maturities of short-term investments.

Financing activities provided net cash of approximately $72,000 for the nine months ended September 30, 2010 resulting from the issuance of common stock due to the exercise of stock options.

On July 24, 2009, we raised gross proceeds of $1,251,000 through the private placement to eight accredited investors of an aggregate of 1,345,161 shares of our common stock and warrants to purchase an aggregate of 672,581 shares of our common stock, representing 50% of the shares of common stock purchased by each investor. We sold the shares to investors at a price per share equal to $0.93. The warrants have an exercise price of $1.12, are exercisable immediately and will terminate on July 24, 2014. For the nine months ended September 30, 2009, $84,000 of cash was also provided by the exercise of stock options.

Contractual Obligations and Commercial Commitments

The following tables summarize our approximate minimum contractual obligations and commercial commitments as of December 31, 2009:

	Payments Due in Period				
	Total	Within 1 Year	Years 1 3	Years 3 5	More than 5 Years
Leases	$ 186,000	$ 101,000	$ 85,000	$	$
Employment Contracts	244,000	195,000	49,000		
Total	$ 430,000	$ 296,000	$ 134,000	$	$

Certain Risks and Uncertainties

Certain statements in this prospectus, including certain statements contained in Description of Business and Management s Discussion and Analysis, constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The words or phrases can be, may, could, would, expects, believes, seeks, estimates, projects and sim phrases are intended to identify such forward-looking statements. Such forward-looking statements are subject to

various known and unknown risks and uncertainties, including those described on the following pages, and we caution you that any forward-looking information provided by us is not a guarantee of future performance. Our actual results could differ materially from those anticipated by such forward-looking statements due to a number of factors, some of which are beyond our control. All such forward-looking statements are current only as of the date on which such statements were made. We do not undertake any obligation to publicly update any forward-looking statement to reflect events or circumstances after the date on which any such statement is made or to reflect the occurrence of unanticipated events.

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BUSINESS

Overview

Founded in 1997, we are a Delaware corporation that has been engaged primarily in the development of hemodiafiltration, or HDF, products and technologies for treating patients with End Stage Renal Disease, or ESRD. In January 2006, we introduced our new Dual Stage Ultrafilter (the DSU) water filtration system, which represents a new and complementary product line to our existing ESRD therapy business.

We currently have three products in various stages of development in the HDF modality to deliver improved therapy to ESRD patients:

OLpur MDHDF filter series (which we sell in various countries in Europe and currently consists of our MD190 and MD220 diafilters); to our knowledge, the only filter designed expressly for HDF therapy and employing our proprietary Mid-Dilution Diafiltration technology;
OLpur H_2H, our add-on module designed to allow the most common types of hemodialysis machines to be used for HDF therapy; and
OLpur NS2000 system, our stand-alone HDF machine and associated filter technology.

We have also developed our OLpur HD 190 high-flux dialyzer cartridge, which incorporates the same materials as our OLpur MD series but does not employ our proprietary Mid-Dilution Diafiltration technology. Our OLpur HD190 was designed for use with either hemodialysis or hemodiafiltration machines, and received its approval from the U.S. Food and Drug Administration, or FDA, under Section 510(k) of the Food, Drug and Cosmetic Act, or the FDC Act, in June 2005.

OLpur and H_2H are among our trademarks for which U.S. registrations are pending. H_2H is a registered European Union trademark. We have assumed that the reader understands that these terms are source-indicating. Accordingly, such terms appear throughout the remainder of this prospectus without trademark notices for convenience only and should not be construed as being used in a descriptive or generic sense.

We believe that products in our OLpur MDHDF filter series are more effective than any products currently available for ESRD therapy because they are better at removing certain larger toxins (known in the industry as middle molecules because of their heavier molecular weight) from blood. The accumulation of middle molecules in the blood has been related to such conditions as malnutrition, impaired cardiac function, carpal tunnel syndrome, and degenerative bone disease in the ESRD patient. We also believe that OLpur H_2H will, upon introduction, expand the use of HDF as a cost-effective and attractive alternative for ESRD therapy, and that, if approved in 2010, our OLpur H_2H and MDHDF filters will be the first, and only, HDF therapy available in the United States at that time.

We believe that our products will reduce hospitalization, medication and care costs as well as improve patient health (including reduced drug requirements and improved blood pressure profiles), and therefore, quality of life, by removing a broad range of toxins through a more patient-friendly, better-tolerated process. In addition, independent studies in Europe have indicated that, when compared with dialysis as it is currently offered in the United States, HDF can reduce the patient s mortality risk by up to 35%. We believe that the OLpur MDHDF filter series and the OLpur H_2H will provide these benefits to ESRD patients at competitive costs and without the need for ESRD treatment providers to make significant capital expenditures in order to use our products. We also believe that the OLpur NS2000 system, if successfully developed, will be the most cost-effective stand-alone hemodiafiltration system available.

In the first quarter of 2007, we received approval from the FDA for our Investigational Device Exemption (IDE) application for the clinical evaluation of our OLpur H_2H module and OLpur MD 220 filter. We completed the patient treatment phase of our clinical trial during the second quarter of 2008. We submitted our data to the FDA with our 510(k) application on these product s in November 2008. Following its review of the application, the FDA requested additional information from us. We replied to the FDA inquiries on March 13, 2009. On June 30, 2010, we received a final decision letter from the FDA for our 510(k) submission, which stated that the FDA could not reach a substantial equivalence determination for our hemodiafiltration, or HDF, system. An in-person meeting with the FDA took place on September 10, 2010 to

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discuss the issues raised in the FDA letter. We are evaluating our future course of action. The current decision by the U.S. FDA with regard to our HDF system does not impact our ability to market and sell our mid-dilution (MD) filters for hemodiafiltration procedures outside of the U.S.

In January 2006, we introduced our new Dual Stage Ultrafilter (the DSU) water filtration system. Our DSU represents a new and complementary product line to our existing ESRD therapy business. The DSU incorporates our unique and proprietary dual stage filter architecture and is, to our knowledge, the only water filter that allows the user to sight-verify that the filter is properly performing its cleansing function. Our research and development work on the OLpur H_2H and MD Mid-Dilution filter technologies for ESRD therapy provided the foundations for a proprietary multi-stage water filter that we believe is cost effective, extremely reliable, and long-lasting. We believe our DSU can offer a robust solution to a broad range of contaminated water and disease prevention issues. Hospitals are particularly stringent in their water quality requirements; transplant patients and other individuals whose immune systems are compromised can face a substantial infection risk in drinking or bathing with standard tap water that would generally not present a danger to individuals with normal immune function. The DSU is designed to remove a broad range of bacteria, viral agents and toxic substances, including salmonella, hepatitis, cholera, HIV, Ebola virus, ricin toxin, legionella, fungi and e-coli. With over 5,800 registered hospitals in the United States alone (as reported by the American Hospital Association in Fast Facts of November 11, 2009), we believe the hospital shower and faucet market can offer us a valuable opportunity as a first step in water filtration.

Due to the ongoing concerns of maintaining water quality, on October 7, 2008, we filed a 510(k) application for approval to market our DSU to dialysis clinics for in-line purification of dialysate water. On July 1, 2009, we received FDA approval of the DSU to be used to filter biological contaminants from water and bicarbonate concentrate used in hemodialysis procedures.

During the twelve months ended December 31, 2009, we were granted four new patents. In the U.S., we were issued patent #7,534,349 for a Dual Stage Ultrafilter with pump mechanism and/or shower feature. In Canada, we were issued patent #2,430,575 for a valve mechanism used in Infusion Fluid systems which is a feature used on our H_2H module and patent #2,396,852 for an Ionic Enhanced Dialysis/Diafiltration system which is related to mid-dilution HDF. In China, we were issued patent #200510092067.3 for a Dual Stage Hemodiafiltration cartridge used in its OLpur MD HDF Filter.

In 2006, the U.S. Defense Department budget included an appropriation for the U.S. Marine Corps for development of a dual stage water ultra filter. In connection with this Federal appropriation of approximately $1 million, we worked on the development of a personal potable water purification system for use by warfighters. Work on this project was completed in August 2009 and we have billed approximately $900,000 during the twenty months ended August 2009. In August 2009, we were awarded a new $1.8 million research contract from the Office of Naval Research (ONR) for development of a potable dual-stage military water purifying filter. The research contract is an expansion of our former ONR contract which is being performed as part of the Marine Corps Advanced Technology Demonstration (ATD) project. The primary objective of this expanded research program is to select concepts and functional prototype filter/pump units which were developed during the first phase of the project, and further develop them into smaller field-testable devices that can be used for military evaluation purposes. An advantage of our ultrafilter is the removal of viruses which are not removed with commercially available off-the-shelf microfilter devices. Such devices generally rely on a secondary chemical disinfection step to make the water safe to drink. The expanded contract also includes research geared toward improving membrane performance, improving device durability, developing larger squad-level water purifier devices, and investigating desalination filter/pump devices for emergency-use purposes. Approximately $1,178,000 of revenue has been recognized on this second project since September 2009, of which approximately $755,000 was recognized during the nine months ended September 30, 2010.

We have also introduced the DSU to various government agencies as a solution to providing potable water in certain emergency response situations. We have also begun investigating a range of commercial, industrial and retail opportunities for our DSU technology.

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Going Concern

Our independent registered public accounting firm has included an explanatory paragraph in its report on our financial statements included in this prospectus which expresses doubt as to our ability to continue as a going concern. The financial statements included in this prospectus have been prepared assuming that we will continue as a going concern, however, there can be no assurance that we will be able to do so. Our recurring losses and difficulty in generating sufficient cash flow to meet our obligations and sustain our operations raise substantial doubt about our ability to continue as a going concern. Our consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

We have incurred losses in our operations in each quarter since inception. For the years ended December 31, 2009 and 2008, we incurred net losses of $2,026,000 and $6,337,000, respectively. In addition, we have not generated positive cash flow from operations for the years ended December 31, 2009 and 2008. To become profitable, we must increase revenue substantially and achieve and maintain positive gross and operating margins. If we are not able to increase revenue and gross and operating margins sufficiently to achieve profitability, our results of operations and financial condition will be materially and adversely affected.

At December 31, 2009, we had $1,004,000 in cash and cash equivalents. There can be no assurance that our cash and cash equivalents will provide the liquidity we need to continue our operations. (See Certain Risks and Uncertainties .) These operating plans primarily include the continued development and support of our business in the European and Canadian markets, organizational changes necessary to enhance the commercialization of our water filtration business and the completion of current year milestones which are included in the Office of Naval Research appropriation.

We are undertaking this rights offering to raise capital to support our continued operations. If this rights offering is not completed, we do not expect we will be able to continue operating and would begin to wind down our operations.

If this rights offering is successful, we will continue to investigate additional funding opportunities by talking to various potential investors who could provide financing. However, there can be no assurance that we will be able to obtain further financing, do so on reasonable terms or do so on terms that would not substantially dilute your equity interests in us. If we are unable to raise additional funds on a timely basis, or at all, we may not be able to continue our operations.

There can be no assurance that our future cash flow will be sufficient to meet our obligations and commitments. If we are unable to generate sufficient cash flow from operations in the future to service our commitments we will be required to adopt alternatives, such as seeking to raise debt or equity capital, curtailing our planned activities or ceasing our operations. There can be no assurance that any such actions could be effected on a timely basis or on satisfactory terms or at all, or that these actions would enable us to continue to satisfy our capital requirements.

Delisting of Stock from AMEX

On September 12, 2008, we received a letter from the NYSE Alternext US LLC (formerly, the American Stock Exchange or AMEX) notifying us of our noncompliance with certain continued listing standards.

In response to that letter, we submitted a plan of compliance to the AMEX on October 13, 2008 advising the AMEX of the actions we have taken, or will take, that would bring us into compliance with the continued listing standards by April 30, 2009.

On January 8, 2009, we received a letter from the AMEX notifying us that it was rejecting our plan of compliance regarding the following listing standards to which we were in noncompliance of:

Section 1003(a)(iii), which states AMEX will normally consider suspending dealings in, or removing from the list, securities of an issuer which has stockholders equity of less than $6,000,000 if such issuer has sustained net losses in its five most recent fiscal years;

Section 1003(a)(ii), which states AMEX will normally consider suspending dealings in, or removing from the list, securities of an issuer which has stockholders equity of less than $4,000,000 if such issuer has sustained net losses in its three of its four most recent fiscal years; and

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Section 1003(f)(v), which states AMEX will normally consider suspending dealings in, or removing from the list, common stock that sells for a substantial period of time at a low price per share.

The AMEX further stated that the AMEX intended to strike our common stock from the AMEX by filing a delisting application with the SEC pursuant to Rule 1009(d) of the AMEX Company Guide. Given the turmoil in the capital markets, we decided not to seek an appeal of the AMEX s intention to delist our common stock.

On January 22, 2009, we were informed by the AMEX that they had suspended trading in our common stock effective immediately. Immediately following the notification, our common stock was no longer traded on the AMEX.

Effective February 4, 2009, our common stock was quoted on the Over the Counter Bulletin Board under the symbol NEPH.OB .

In a letter dated April 13, 2009, we received a copy of the AMEX s application to strike our common stock from the AMEX.

Current ESRD Therapy Options

Current renal replacement therapy technologies include (1) two types of dialysis, peritoneal dialysis and hemodialysis, (2) hemofiltration and (3) hemodiafiltration, a combination of hemodialysis and hemofiltration. Dialysis can be broadly defined as the process that involves movement of molecules across a semipermeable membrane. In hemodialysis, hemofiltration or hemodiafiltration, the blood is exposed to an artificial membrane outside of the body. During Peritoneal Dialysis (PD), the exchange of molecules occurs across the membrane lining of the patient s peritoneal cavity. While there are variations in each approach, in general, the three major categories of renal replacement therapy in the marketplace today are defined as follows:

Dialysis

- *Peritoneal Dialysis*, or PD, uses the patient s peritoneum, the membrane lining covering the internal abdominal organs, as a filter by introducing injectable-grade dialysate solution into the peritoneal cavity through a surgically implanted catheter. After some period of time, the fluid is drained and replaced. PD is limited in use because the
  - peritoneal cavity is subject to scarring with repeated episodes of inflammation of the peritoneal membrane, reducing the effectiveness of this treatment approach. With time, a PD patient s kidney function continues to deteriorate and peritoneal toxin removal alone may become insufficient to provide adequate treatment. In such case the patient may switch to an extracorporeal renal replacement therapy such as hemodialysis or hemodiafiltration.
- *Hemodialysis* uses an artificial kidney machine to remove certain toxins and fluid from the patient s blood while controlling external blood flow and monitoring patient vital signs. Hemodialysis patients are connected to a dialysis
  - machine via a vascular access device. The hemodialysis process occurs in a dialyzer cartridge with a semi-permeable membrane which divides the dialyzer into two chambers: while the blood is circulated through one chamber, a premixed solution known as dialysate circulates through the other chamber. Toxins and excess fluid from the blood cross the membrane into the dialysate solution through a process known as diffusion.

Hemofiltration is a cleansing process without dialysate solution where blood is passed through a semi-permeable membrane, which filters out solute particles.

Hemodiafiltration, or HDF, in its basic form combines the principles of hemodialysis with hemofiltration. HDF uses dialysate solution with a negative pressure (similar to a vacuum effect) applied to the dialysate solution to draw additional toxins from the blood and across the membrane. This process is known as convection. HDF thus combines diffusion with convection, offering efficient removal of small solutes by diffusion, with improved removal of larger substances (i.e., middle molecules) by convection.

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Hemodialysis is the most common form of extracorporeal renal replacement therapy and is generally used in the United States. Hemodialysis fails, in our opinion, to address satisfactorily the long-term health or overall quality of life of the ESRD patient. We believe that the HDF process, which is currently available in our Target European Market and Japan, offers improvement over other dialysis therapies because of better ESRD patient tolerance, superior blood purification of both small and middle molecules, and a substantially improved mortality risk profile.

Current Dialyzer Technology used with HDF Systems

In our view, treatment efficacy of current HDF systems is limited by current dialyzer technology. As a result of the negative pressure applied in HDF, fluid is drawn from the blood and across the dialyzer membrane along with the toxins removed from the blood. A portion of this fluid must be replaced with a man-made injectable grade fluid, known as substitution fluid, in order to maintain the blood s proper fluid volume. With the current dialyzer technology, fluid is replaced in one of two ways: pre-dilution or post-dilution.

With pre-dilution, substitution fluid is added to the blood before the blood enters the dialyzer cartridge. In this process, the blood can be over-diluted, and therefore more fluid can be drawn across the membrane. This enhances removal of toxins by convection. However, because the blood is diluted before entering the device, it actually reduces the rate of removal by diffusion; the overall rate of removal, therefore, is reduced for small molecular weight toxins (such as urea) that rely primarily on diffusive transport.

With post-dilution, substitution fluid is added to blood after the blood has exited the dialyzer cartridge. This is the currently preferred method because the concentration gradient is maintained at a higher level, thus not impairing the rate of removal of small toxins by diffusion. The disadvantage of this method, however, is that there is a limit in the amount of plasma water that can be filtered from the blood before the blood becomes too viscous, or thick. This limit is approximately 20% to 25% of the blood flow rate. This limit restricts the amount of convection, and therefore limits the removal of middle and larger molecules.

The Nephros Mid-Dilution Diafiltration Process

Our OLpur MDHDF filter series uses a design and process we developed called Mid-Dilution Diafiltration, or MDF. MDF is a fluid management system that optimizes the removal of both small toxins and middle-molecules by offering the advantages of pre-dilution HDF and post-dilution HDF combined in a single dialyzer cartridge. The MDF process involves the use of two stages: in the first stage, blood is filtered against a dialysate solution, therefore providing post-dilution diafiltration; it is then overdiluted with sterile infusion fluid before entering a second stage, where it is filtered once again against a dialysate solution, therefore providing pre-dilution diafiltration. We believe that the MDF process provides improved toxin removal in HDF treatments, with a resulting improvement in patient health and concurrent reduction in healthcare costs.

Our ESRD Therapy Products

Our products currently available or in development with respect to ESRD Therapy include:

OLpur MDHDF Filter Series

OLpur MD190 and MD220 constitute our dialyzer cartridge series that incorporates the patented MDF process and is designed for use with existing HDF platforms currently prevalent in our Target European Market and Japan. Our MDHDF filter series incorporates a unique blood-flow architecture that enhances toxin removal with essentially no cost increase over existing devices currently used for HDF therapy.

Laboratory bench studies have been conducted on our OLpur MD190 by members of our research and development staff and by a third party. We completed our initial clinical studies to evaluate the efficacy of our OLpur MD190 as compared to conventional dialyzers in Montpellier, France in 2003. The results from this clinical study support our belief that OLpur MD190 is superior to post-dilution hemodiafiltration using a standard high-flux dialyzer with respect to §2-microglobulin clearance. In addition, clearances of urea, creatinine, and phosphate met the design specifications proposed for the OLpur MD190 device. Furthermore, adverse event data from the study suggest that hemodiafiltration with our OLpur MD190 device was well tolerated by the patients and safe.

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We have initiated longer term clinical studies in the United Kingdom, France, Germany, Italy and Spain to further demonstrate the therapeutic benefits of our OLpur MDHDF filter series. A multi-center study was started in March 2005. This study encompassed seven centers in France, five centers in Germany and one center in Sweden. Also commencing in 2005 were studies in the United Kingdom and in Italy. A three-month study was conducted in Spain. All enrolled patients in the multi-center and Spain studies completed the investigational period with the Nephros OLpur MDHDF filter devices. Initial data is very positive, demonstrating improved low-molecular weight protein removal, improvements in appetite, an overall improved distribution of fluids and body composition, and optimal toxin removal and treatment tolerance for patients suffering from limited vascular access. Data was presented at the American Society of Nephrology meeting held in November 2006.

We contracted with TÜV Rheinland of North America, Inc., a worldwide testing and certification agency (also referred to as a notified body) that performs conformity assessments to European Union requirements for medical devices, to assist us in obtaining the Conformité Européene, or CE mark, a mark which demonstrates compliance with relevant European Union requirements. We received CE marking on the OLpur MD190 (which also covers other dialyzers in our MDHDF filter series), as well as certification of our overall quality system, on July 31, 2003. In the fourth quarter of 2006 we received CE marking on the DSU.

In November 2007, the Therapeutic Products Directorate of Health Canada, the Canadian health regulatory agency, approved our OLpur MDHDF filter series for marketing in Canada.

We initiated marketing of our OLpur MD190 in our Target European Market in March 2004. We have established a sales presence in countries throughout our Target European Market, mainly through distributors, and we have developed marketing material in the relevant local languages. We also attend trade shows where we promote our product to several thousand people from the industry. Our OLpur MD220 is a new product that we began selling in our Target European Market in 2006. The OLpur MD220 employs the same technology as our OLpur MD190, but contains a larger surface area of fiber. Because of its larger surface area, the OLpur MD220 may provide greater clearance of certain toxins than the OLpur MD190, and is suitable for patients of larger body mass.

We are currently offering the OLpur MD190 and OLpur MD220 at a price comparable to the existing high performance dialyzers sold in the relevant market. We are unable at this time to determine what the market prices will be in the future.

In the first quarter of 2007, we received approval from the FDA for our Investigational Device Exemption (IDE) application for the clinical evaluation of our OLpur H_2H module and OLpur MD 220 filter. We completed the patient treatment phase of our clinical trial during the second quarter of 2008. We have submitted our data to the FDA with our 510(k) application on these products in November 2008. Following its review of the application, the FDA has requested additional information from us. We replied to the FDA inquiries on March 13, 2009. On June 30, 2010, we received a final decision letter from the FDA for our 510(k) submission, which stated that the FDA could not reach a substantial equivalence determination for our hemodiafiltration, or HDF, system. An in-person meeting with the FDA took place on September 10, 2010 to discuss the issues raised in the FDA letter. We are evaluating our future course of action. The current decision by the U.S. FDA with regard to our HDF system does not impact our ability to market and sell our mid-dilution (MD) filters for hemodiafiltration procedures outside of the U.S

OLpur HD190

OLpur HD190 is our high-flux dialyzer cartridge, designed for use with either hemodialysis or hemodiafiltration machines. The OLpur HD190 incorporates the same materials as our OLpur MD190, but lacks our proprietary

mid-dilution architecture.

OLpur H_2H

OLpur H_2H is our add-on module that converts the most common types of hemodialysis machines that is, those with volumetric ultrafiltration control into HDF-capable machines allowing them to use our OLpur MDHDF filter. We have completed our OLpur H_2H design and laboratory bench testing, all of which were conducted by members of our research and development staff. Our design verification of the OLpur H_2H was completed making the device ready for U.S. clinical trial. We completed the patient treatment phase of our

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clinical trial during the second quarter of 2008. We submitted our data to the FDA with our 510(k) application on these products in November 2008. Following its review of the application, the FDA requested additional information from us. We replied to the FDA inquiries on March 13, 2009. On June 30, 2010, we received a final decision letter from the FDA for our 510(k) submission, which stated that the FDA could not reach a substantial equivalence determination for our hemodiafiltration, or HDF, system. An in-person meeting with the FDA took place on September 10, 2010 to discuss the issues raised in the FDA letter. We are evaluating our future course of action. The current decision by the U.S. FDA with regard to our HDF system does not impact our ability to market and sell our mid-dilution (MD) filters for hemodiafiltration procedures outside of the U.S.

OLpur NS2000

OLpur NS2000 is our standalone HDF machine and associated filter technology, which is in the development stage. The OLpur NS2000 will use a basic HDF platform which will incorporate our H_2H technology including our proprietary substitution fluid systems.

We have also designed and developed proprietary substitution fluid filter cartridges for use with the OLpur NS2000, which have been subjected to pre-manufacturing testing. We will need to obtain the relevant regulatory clearances prior to any market introduction of our OLpur NS2000 in the United States.

Our Water Filtration Product

In January 2006, we introduced our Dual Stage Ultrafilter, or DSU, water filtration system. The DSU incorporates our unique and proprietary dual stage filter architecture. Our research and development work on the OLpur H_2H and MD filter technologies for ESRD therapy provided the foundations for a proprietary multi-stage water filter that we believe is cost effective, extremely reliable, and long-lasting. We believe our DSU can offer a robust solution to various contaminated water and infection control issues. The DSU is designed to remove a broad range of bacteria, viral agents and toxic substances, including salmonella, hepatitis, cholera, HIV, Ebola virus, ricin toxin, legionella, fungi and e-coli. We believe our DSU offers four distinct advantages over competitors in the water filtration marketplace:

1) the DSU is, to our knowledge, the only water filter that provides the user with a simple sight verification that the filter is properly performing its cleansing function due to our unique dual-stage architecture;
2) the DSU filters finer biological contaminants than other filters of which we are aware in the water filtration marketplace;
3) the DSU filters relatively large volumes of water before requiring replacement; and
4) the DSU continues to protect the user even if the flow is reduced by contaminant volumes, because contaminants do not cross the filtration medium.

With over 5,000 registered hospitals in the United States alone, we believe the hospital shower and faucet market can offer us a valuable opportunity as a first step in water filtration. We hope to gain a foothold at U.S. and European facilities that seek to become centers of excellence in infection control through the use of our DSU products.

Due to the ongoing concerns of maintaining water quality, on October 7, 2008, we filed a 510(k) application for approval to market our DSU to dialysis clinics for in-line purification of dialysate water. On July 1, 2009, we received FDA approval of the DSU to be used to filter biological contaminants from water and bicarbonate concentrate used in hemodialysis procedures.

In 2006, the U.S. Defense Department budget included an appropriation for the U.S. Marine Corps for development of a dual stage water ultra filter. In connection with this Federal appropriation of approximately $1 million, we worked

on the development of a personal potable water purification system for use by warfighters. Work on this project was completed in August 2009 and we have billed approximately $900,000 during the twenty months ended August 2009. In August 2009, we were awarded a new $1.8 million research contract from the Office of Naval Research (ONR) for development of a potable dual-stage military water purifying filter. The research contract is an expansion of our former ONR contract which is being performed

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as part of the Marine Corps Advanced Technology Demonstration (ATD) project. The primary objective of this expanded research program is to select concepts and functional prototype filter/pump units which were developed during the first phase of the project, and further develop them into smaller field-testable devices that can be used for military evaluation purposes. An advantage of our ultrafilter is the removal of viruses which are not removed with commercially available off-the-shelf microfilter devices. Such devices generally rely on a secondary chemical disinfection step to make the water safe to drink. The expanded contract also includes research geared toward improving membrane performance, improving device durability, developing larger squad-level water purifier devices, and investigating desalination filter/pump devices for emergency-use purposes. Approximately $1,178,000 of revenue has been recognized on this second project since September 2009, of which approximately $755,000 was recognized during the nine months ended September 30, 2010.

We have also introduced the DSU to various government agencies as a solution to providing potable water in certain emergency response situations. We have also begun investigating a range of commercial, industrial and retail opportunities for our DSU technology.

Our Strategy

We believe that current mortality and morbidity statistics, in combination with quality of life issues faced by the ESRD patient, has generated demand for improved ESRD therapies. We also believe that our products and patented technology offer the ability to remove toxins more effectively than current dialysis therapy, in a cost framework competitive with currently available, less-effective therapies. The following are some highlights of our current strategy:

Showcase Product Efficacy in our Target European Market: As of March 2004, we initiated marketing in our Target European Market for the OLpur MD190. There is an opportunity for sales of the OLpur MDHDF filters in our Target European Market because there is an established HDF machine base using disposable dialyzers. We have engaged in a series of clinical trials throughout our Target European Market to demonstrate the superior efficacy of our product. We believe that by demonstrating the effectiveness of our MDHDF filter series we will encourage more customers to purchase our products. Our MDHDF filter series has been applied successfully in over 150,000 treatments to date.

Convert Existing Hemodialysis Machines to Hemodiafiltration: Upon completion of the appropriate documentation for our OLpur H_2H technology, we plan to apply for CE marking for our OLpur H_2H during 2010. We plan to complete our regulatory approval processes in the United States for both our OLpur MDHDF filter series and our OLpur H_2H in 2009. If successfully approved, our OLpur H_2H product will enable HDF therapy using the most common types of hemodialysis machines together with our OLpur MDHDF filters. Our goal is to achieve market penetration by offering the OLpur H_2H for use by healthcare providers inexpensively, thus permitting the providers to use the OLpur H_2H without a large initial capital outlay. We do not expect to generate significant positive margins from sales of OLpur H_2H. We believe H_2H will provide a basis for more MDHDF filter sales. We believe that, if approved, our OLpur H_2H and MDHDF filters will be the first, and only, HDF therapy available in the United States at that time.

Upgrade Dialysis Clinics to OLpur NS2000: We believe the introduction of the OLpur NS2000 will represent a further upgrade in performance for dialysis clinics by offering a cost-effective stand-alone HDF solution that incorporates the benefits of our OLpur H_2H technology. We believe dialysis clinics will entertain OLpur NS2000 as an alternative to their current technology at such dialysis clinic s machine replacement point.

Develop a Foothold in the Healthcare Arena by Offering our DSU as a Means to Control Environment-Acquired Infections: We believe our DSU offers an effective, and cost-effective, solution in conquering certain infection control issues faced by hospitals, nursing homes, assisted living facilities and other patient environments where chemical or heat alternatives have typically failed to adequately address the problem. The DSU provides for simple implementation without large capital expenses. We have established a goal in 2010 to gain a foothold at U.S. and European facilities that seek to become centers of excellence in infection control through the use of our DSU products.

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Pursue our Military Product Development in Conjunction with Value-Adding Partners: For our military development, we are engaging with strategic allies who offer added value with respect to both new product and marketing opportunities. One of our goals in pursuing this project is to maintain and expand our new product development pipeline and achieve new products suitable for both military and domestic applications.

Explore Complementary Product Opportunities: Where appropriate, we are also seeking to leverage our technologies and expertise by applying them to new markets. Our H_2H has potential applications in acute patient care and controlled provision of ultrapure fluids in the field. Our DSU represents a new and complementary product line to our existing ESRD therapy business; we believe the Nephros DSU can offer a robust solution to a broad range of contaminated water and infection control issues.

Manufacturing and Suppliers

We do not intend to manufacture any of our products or components. We have entered into an agreement dated May 12, 2003, with a contract manufacturer (CM) to assemble and produce our OLpur MD190, MD220 or other filter products at our option. The agreement requires us to utilize this CM to manufacture the OLpur MD190s and MD220s or other filter products that we directly market in Europe, or are marketed by our distributor. In addition, our CM will be given first consideration in good faith for the manufacture of OLpur MD190s, MD220s or other filter products that we do not directly market. No less than semiannually, our CM will provide a report to representatives of both parties to the agreement detailing any technical know-how that they have developed that would permit them to manufacture the filter products less expensively and both parties will jointly determine the actions to be taken with respect to these findings. If the fiber wastage with respect to the filter products manufactured in any given year exceeds 5%, then the CM will reimburse us up to half of the cost of the quantity of fiber represented by excess wastage. The CM will manufacture the OLpur MD190 or other filter products in accordance with the quality standards outlined in the agreement. Upon recall of any OLpur MD190 or other filter product due to manufactured products that fail to conform to the required specifications or having failed to manufacture one or more products in accordance with any applicable laws, the CM will be responsible for the cost of recall. The agreement also requires that we maintain certain minimum product-liability insurance coverage and that we indemnify our CM against certain liabilities arising out of our products that they manufacture, providing they do not arise out of the CM s breach of the agreement, negligence or willful misconduct. The term of the agreement is through May 12, 2010, with successive automatic one-year renewal terms, until either party gives the other notice that it does not wish to renew at least 90 days prior to the end of the term. The agreement may be terminated prior to the end of the term by either party upon the occurrence of certain insolvency-related events or breaches by the other party. Although we have no separate agreement with respect to such activities, our CM has also been manufacturing our H_2H filters and DSU in limited quantities.

We also entered into an agreement in December 2003, and amended in June 2005, with a fiber supplier (FS), a manufacturer of medical and technical membranes for applications like dialysis, to continue to produce the fiber for the OLpur MDHDF filter series. Pursuant to the agreement, FS is our exclusive provider of the fiber for the OLpur MDHDF filter series in the European Union as well as certain other territories. On January 18, 2010 the FS notified us that they are exercising their right to terminate the supply agreement. Termination of the supply agreement will be effective on July 18, 2010. The FS noted their desire to negotiate and execute a new supply agreement with us. Negotiations on terms of a new supply agreement have been taking place and we expect to execute a new agreement with the FS, although we cannot assure you that we will be able to do so.

Sales and Marketing

We have established a distributor network to sell ESRD products in our Target European Market and, when regulatory approval is obtained, intend to establish a similar arrangement in the United States. On February 25, 2010, we announced that we signed an exclusive distribution agreement with Bellco Health Care Inc. (BHC Medical) to sell and market Nephros OLpurTM MD 220 filter for on-line HDF therapy in Canada. Under the terms of the Agreement, Nephros and BHC Medical will work together to promote the sale and distribution of Nephros OLpurTM MD 220 filters through various advertising and promotional campaigns and by working with and training BHC s sales and support staff.

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We have established a customer service and financial processing facility in Dublin, Ireland, available to our customer base in our Target European Market. We have also initiated and completed various clinical studies designed to continue our evaluation of effectiveness of the OLpur MDHDF filters when used on ESRD patients in our Target European Market. These studies are intended to provide us, and have provided us, with valuable information regarding the efficacy of our product and an opportunity to introduce OLpur MDHDF filters to medical institutions in our Target European Market. We have engaged a medical advisor to help us in structuring our clinical study protocols and to support physicians technical inquiries regarding our products.

We are marketing our ESRD products primarily to healthcare providers such as hospitals, dialysis clinics, managed care organizations, and nephrology physician groups. We ship our products to these customers both directly from our manufacturer, where this is cost-effective, our distributors, and a public warehouse facility in the U.S.

Our New Jersey office oversees sales and marketing activity of our DSU products. We are in discussions with several medical products and filtration products suppliers to act as non-exclusive distributors of our DSU products to medical institutions. For each prospective market for our DSU products, we are pursuing alliance opportunities for joint product development and distribution. Our DSU manufacturer in Europe shares certain intellectual property rights with us for one of our DSU designs.

Research and Development

Our research and development efforts continue on several fronts directly related to our current product lines. We are also working on additional machine devices, next-generation user interface enhancements and other product enhancements.

In the area of water filtration, we have finalized our initial water filtration product line for the healthcare sector.

In 2006, the U.S. Defense Department budget included an appropriation for the U.S. Marine Corps for development of a dual stage water ultra filter. In connection with this Federal appropriation of approximately $1 million, we worked on the development of a personal potable water purification system for use by warfighters. Work on this project was completed in August 2009 and we have billed approximately $900,000 during the twenty months ended August 2009. In August 2009, we were awarded a new $1.8 million research contract from the Office of Naval Research (ONR) for development of a potable dual-stage military water purifying filter. The research contract is an expansion of our former ONR contract which is being performed as part of the Marine Corps Advanced Technology Demonstration (ATD) project. The primary objective of this expanded research program is to select concepts and functional prototype filter/pump units which were developed during the first phase of the project, and further develop them into smaller field-testable devices that can be used for military evaluation purposes. An advantage of our ultrafilter is the removal of viruses which are not removed with commercially available off-the-shelf microfilter devices. Such devices generally rely on a secondary chemical disinfection step to make the water safe to drink. The expanded contract also includes research geared toward improving membrane performance, improving device durability, developing larger squad-level water purifier devices, and investigating desalination filter/pump devices for emergency-use purposes. Approximately $423,000 has been billed to this second project during the four months ended December 31, 2009.

We have also introduced the DSU to various government agencies as a solution to providing potable water in certain emergency response situations. We have also begun investigating a range of commercial, industrial and retail opportunities for our DSU technology.

Our research and development expenditures were primarily related to development expenses associated with the H_2H machine and related salary expenses for the years ended December 31, 2009 and 2008 and were $280,000 and $1,977,000, respectively, and were $259,000 and $212,000, respectively, for the nine months ended September 30, 2010 and 2009.

Competition

The dialyzer and renal replacement therapy market is subject to intense competition. Accordingly, our future success will depend on our ability to meet the clinical needs of physicians and nephrologists, improve patient outcomes and remain cost-effective for payors.

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We compete with other suppliers of ESRD therapies, supplies and services. These suppliers include Fresenius Medical Care AG, and Gambro AB, currently two of the primary machine manufacturers in hemodialysis. At present, Fresenius Medical Care AG and Gambro AB also manufacture HDF machines.

The markets in which we sell our dialysis products are highly competitive. Our competitors in the sale of hemodialysis products include Gambro AB, Baxter International Inc., Asahi Kasei Medical Co. Ltd., Bellco S.p.A., a subsidiary of the Sorin group, B. Braun Melsungen AG, Nipro Corporation Ltd., Nikkiso Co., Ltd., Terumo Corporation and Toray Medical Co., Ltd.

Other competitive considerations include pharmacological and technological advances in preventing the progression of ESRD in high-risk patients such as those with diabetes and hypertension, technological developments by others in the area of dialysis, the development of new medications designed to reduce the incidence of kidney transplant rejection and progress in using kidneys harvested from genetically-engineered animals as a source of transplants.

We are not aware of any other companies using technology similar to ours in the treatment of ESRD. Our competition would increase, however, if companies that currently sell ESRD products, or new companies that enter the market, develop technology that is more efficient than ours. We believe that in order to become competitive in this market, we will need to develop and maintain competitive products and take and hold sufficient market share from our competitors. Therefore, we expect our methods of competing in the ESRD marketplace to include:

continuing our efforts to develop, have manufactured and sell products which, when compared to existing products, perform more efficiently and are available at prices that are acceptable to the market;
displaying our products and providing associated literature at major industry trade shows in the United States, our Target European Market and Canada;
initiating discussions with dialysis clinic medical directors, as well as representatives of dialysis clinical chains, to develop interest in our products;
offering the OLpur H_2H at a price that does not provide us with significant positive margins in order to encourage adoption of this product and associated demand for our dialyzers; and
pursuing alliance opportunities in certain territories for distribution of our products and possible alternative manufacturing facilities.

With respect to the water filtration market, we expect to compete with companies that are well entrenched in the water filtration domain. These companies include Pall Corporation, which manufactures end-point water filtration systems, as well as CUNO (a 3M Company) and US Filter (a Siemens business). Our methods of competition in the water filtration domain include:

developing and marketing products that are designed to meet critical and specific customer needs more effectively than competitive devices;
offering unique attributes that illustrate our product reliability, user-friendliness, and performance capabilities;
selling products to specific customer groups where our unique product attributes are mission-critical; and
pursuing alliance opportunities for joint product development and distribution.

Intellectual Property

Patents

We protect our technology and products through patents and patent applications. In addition to the United States, we also applied for patents in other jurisdictions, such as the European Patent Office, Canada and Japan, to the extent we deem appropriate. We have built a portfolio of patents and applications covering our products, including their

hardware design and methods of hemodiafiltration.

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We believe that our patent strategy will provide a competitive advantage in our target markets, but our patents may not be broad enough to cover our competitors products and may be subject to invalidation claims. Our U.S. patents for the Method and Apparatus for Efficient Hemodiafiltration and for the Dual-Stage Filtration Cartridge, have claims that cover the OLpur MDHDF filter series and the method of hemodiafiltration employed in the operation of the products. Although there are pending applications with claims to the present embodiments of the OLpur H_2H and the OLpur NS2000 products, these products are still in the development stage and we cannot determine if the applications (or the patents that we may issue on them) will also cover the ultimate commercial embodiment of these products. In addition, technological developments in ESRD therapy could reduce the value of our intellectual property. Any such reduction could be rapid and unanticipated. We have applied for patents on our DSU water filtration products to cover various applications in residential, commercial, and remote environments.

As of December 31, 2010, we have sixteen issued U.S. patents; one issued Eurasian patent; four Mexican patents, four South Korean patents, three Russian patents, five Chinese patents, five French patents, six German patents, four Israeli patents, five Italian patents, two Spanish patents, six United Kingdom patents, eight Japanese patents, two Hong Kong patents, and nine Canadian patents. Our issued U.S. patents expire between 2018 and 2022. In addition, we have four pending U.S. patent applications, ten pending patent applications in Canada, eight pending patent applications in the European Patent Office, five pending patent applications in Brazil, three pending patent applications in China, nine pending patent applications in Japan, three pending patent applications in Mexico, one pending patent application in South Korea, one pending patent application in Hong Kong, two pending patent applications in India, two pending patent applications in Israel and one pending patent application in Australia. Our pending patent applications relate to a range of dialysis technologies, including cartridge configurations, cartridge assembly, substitution fluid systems, and methods to enhance toxin removal. We also have pending patent applications on our DSU water filtration system and pump/filter applications related to our Office of Naval Research project.

We have filed U.S. and International patent applications for a redundant ultra filtration device that was jointly invented by one of our employees and an employee of our CM. We and our CM are negotiating commercial arrangements pertaining to the invention and the patent applications.

Trademarks

As of December 31, 2010, we secured registrations of the trademarks CENTRAPUR, H_2H, OLpur and the Arrows Logo in the European Union. Applications for these trademarks are pending registration in the United States. We also have applications for registration of a number of other marks pending in the United States Patent and Trademark Office.

Governmental Regulation

The research and development, manufacturing, promotion, marketing and distribution of our ESRD therapy products in the United States, our Target European Market and other regions of the world are subject to regulation by numerous governmental authorities, including the FDA, the European Union and analogous agencies.

United States

The FDA regulates the manufacture and distribution of medical devices in the United States pursuant to the FDC Act. All of our ESRD therapy products are regulated in the United States as medical devices by the FDA under the FDC Act. Under the FDC Act, medical devices are classified in one of three classes, namely Class I, II or III, on the basis of the controls deemed necessary by the FDA to reasonably ensure their safety and effectiveness.

Class I devices are medical devices for which general controls are deemed sufficient to ensure their safety and effectiveness. General controls include provisions related to (1) labeling, (2) producer registration, (3) defect notification, (4) records and reports and (5) quality service requirements, or QSR.

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Class II devices are medical devices for which the general controls for the Class I devices are deemed not sufficient to ensure their safety and effectiveness and require special controls in addition to the general controls. Special controls include provisions related to (1) performance and design standards, (2) post-market surveillance, (3) patient registries and (4) the use of FDA guidelines.

Class III devices are the most regulated medical devices and are generally limited to devices that support or sustain human life or are of substantial importance in preventing impairment of human health or present a potential, unreasonable risk of illness or injury. Pre-market approval by the FDA is the required process of scientific review to ensure the safety and effectiveness of Class III devices.

Before a new medical device can be introduced to the market, FDA clearance of a pre-market notification under Section 510(k) of the FDC Act or FDA clearance of a pre-market approval, or PMA, application under Section 515 of the FDC Act must be obtained. A Section 510(k) clearance will be granted if the submitted information establishes that the proposed device is substantially equivalent to a legally marketed Class I or Class II medical device or to a Class III medical device for which the FDA has not called for pre-market approval under Section 515. The Section 510(k) pre-market clearance process is generally faster and simpler than the Section 515 pre-market approval process. We understand that it generally takes four to 12 months from the date a Section 510(k) notification is accepted for filing to obtain Section 510(k) pre-market clearance, as is the case with our OLpur H_2H module and OLpur MD 220 filter, and that it could take several years from the date a Section 515 application is accepted for filing to obtain Section 515 pre-market approval, although it may take longer in both cases.

We expect that all of our ESRD therapy products and our DSU will be categorized as Class II devices and that these products will not require clearance of pre-market approval applications under Section 515 of the FDC Act, but will be eligible for marketing clearance through the pre-market notification process under Section 510(k). We have determined that we are eligible to utilize the Section 510(k) pre-market notification process based upon our ESRD therapy and DSU products substantial equivalence to previously legally marketed devices in the United States. However, we cannot assure you:

that we will not need to reevaluate the applicability of the Section 510(k) pre-market notification process to our ESRD therapy and DSU products in the future;

that the FDA will agree with our determination that we are eligible to use the Section 510(k) pre-market notification process; or

that the FDA will not in the future require us to submit a Section 515 pre-market approval application, which would be a more costly, lengthy and uncertain approval process.

The FDA has recently been requiring a more rigorous demonstration of substantial equivalence than in the past and may request clinical data to support pre-market clearance. As a result, the FDA could refuse to accept for filing a Section 510(k) notification made by us or request the submission of additional information. The FDA may determine that any one of our proposed ESRD therapy products is not substantially equivalent to a legally marketed device or that additional information is needed before a substantial equivalence determination can be made. A not substantially equivalent determination, or request for additional data, could prevent or delay the market introduction of our products that fall into this category, which in turn could have a material adverse effect on our potential sales and revenues. Moreover, even if the FDA does clear one or all of our products under the Section 510(k) process, it may clear a product for some procedures but not others or for certain classes of patients and not others.

For any devices cleared through the Section 510(k) process, modifications or enhancements that could significantly affect the safety or effectiveness of the device or that constitute a major change to the intended use of the device will require a new Section 510(k) pre-market notification submission. Accordingly, if we do obtain Section 510(k) pre-market clearance for any of our ESRD therapy and DSU products, we will need to submit another Section 510(k) pre-market notification if we significantly affect that product s safety or effectiveness through subsequent modifications or enhancements.

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If human clinical trials of a device are required in connection with a Section 510(k) notification and the device presents a significant risk, the sponsor of the trial (usually the manufacturer or distributor of the device) will need to file an IDE application prior to commencing human clinical trials. The IDE application must be supported by data, typically including the results of animal testing and/or laboratory bench testing. If the IDE application is approved, human clinical trials may begin at a specific number of investigational sites with a specific number of patients, as specified in the IDE. Sponsors of clinical trials are permitted to sell those devices distributed in the course of the study provided such compensation does not exceed recovery of the costs of manufacture, research, development and handling. An IDE supplement must be submitted to the FDA before a sponsor or investigator may make a change to the investigational plan that may affect its scientific soundness or the rights, safety or welfare of subjects. We submitted our original IDE application to the FDA for our OLpur H_2H hemodiafiltration module and OLpur MD220 filter in May 2006. The FDA answered our application with additional questions in June 2006, and we submitted responses to the FDA questions in December 2006. In January 2007, we received conditional approval for our IDE application from the FDA to begin human clinical trials of our OLpur H_2H hemodiafiltration module and OLpur MD220 hemodiafilter. In March 2007, we received full approval on our IDE application from the FDA to begin human clinical trials of our OLpur H_2H hemodiafiltration module and OLpur MD220 hemodiafilter. We completed the patient treatment phase of our clinical trials during the second quarter of 2008 and filed our 510(k) applications with respect to the OLpur MDHDF filter series and the OLpur H_2H module in November 2008. No IDE was required for our DSU product. On July 1, 2009, we received FDA approval of the DSU to be used to filter biological contaminants from water and bicarbonate concentrate used in hemodialysis procedures. We hope to achieve U.S. regulatory approval of our OLpur H_2H module and OLpur MD 220 filter products during 2010. Following its review of our applications, the FDA requested additional information from us. We replied to the FDA inquiries on March 13, 2009. On June 30, 2010, we received a final decision letter from the FDA for our 510(k) submission, which stated that the FDA could not reach a substantial equivalence determination for our hemodiafiltration, or HDF, system. An in-person meeting with the FDA took place on September 10, 2010 to discuss the issues raised in the FDA letter. We are evaluating our future course of action. The current decision by the U.S. FDA with regard to our HDF system does not impact our ability to market and sell our mid-dilution (MD) filters for hemodiafiltration procedures outside of the U.S.

The Section 510(k) pre-market clearance process can be lengthy and uncertain. It will require substantial commitments of our financial resources and management s time and effort. Significant delays in this process could occur as a result of factors including:

our inability to timely raise sufficient funds;
the FDA s failure to schedule advisory review panels;
changes in established review guidelines;
changes in regulations or administrative interpretations; or
determinations by the FDA that clinical data collected is insufficient to support the safety and effectiveness of one or more of our products for their intended uses or that the data warrants the continuation of clinical studies.

Delays in obtaining, or failure to obtain, requisite regulatory approvals or clearances in the United States for any of our products would prevent us from selling those products in the United States and would impair our ability to generate funds from sales of those products in the United States, which in turn could have a material adverse effect on our business, financial condition, and results of operations.

The FDC Act requires that medical devices be manufactured in accordance with the FDA s current QSR regulations which require, among other things, that:

the design and manufacturing processes be regulated and controlled by the use of written procedures;

the ability to produce medical devices which meet the manufacturer s specifications be validated by extensive and detailed testing of every aspect of the process;

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any deficiencies in the manufacturing process or in the products produced be investigated;
detailed records be kept and a corrective and preventative action plan be in place; and
manufacturing facilities be subject to FDA inspection on a periodic basis to monitor compliance with QSR regulations.

If violations of the applicable QSR regulations are noted during FDA inspections of our manufacturing facilities or the manufacturing facilities of our contract manufacturers, there may be a material adverse effect on our ability to produce and sell our products.

Before the FDA approves a Section 510(k) pre-market notification, the FDA is likely to inspect the relevant manufacturing facilities and processes to ensure their continued compliance with QSR. Although some of the manufacturing facilities and processes that we expect to use to manufacture our ESRD and DSU filters have been inspected and certified by a worldwide testing and certification agency (also referred to as a notified body) that performs conformity assessments to European Union requirements for medical devices, they have not all been inspected by the FDA. Similarly, although some of the facilities and processes that we expect to use to manufacture our OLpur H_2H have been inspected by the FDA, they have not all been inspected by any notified body. A notified body is a group accredited and monitored by governmental agencies that inspects manufacturing facilities and quality control systems at regular intervals and is authorized to carry out unannounced inspections. Even after the FDA has cleared a Section 510(k) submission, it will periodically inspect the manufacturing facilities and processes for compliance with QSR. In addition, in the event that additional manufacturing sites are added or manufacturing processes are changed, such new facilities and processes are also subject to FDA inspection for compliance with QSR. The manufacturing facilities and processes that will be used to manufacture our products have not yet been inspected by the FDA for compliance with QSR. We cannot assure you that the facilities and processes used by us will be found to comply with QSR and there is a risk that clearance or approval will, therefore, be delayed by the FDA until such compliance is achieved.

In addition to the requirements described above, the FDC Act requires that:

all medical device manufacturers and distributors register with the FDA annually and provide the FDA with a list of those medical devices which they distribute commercially;
information be provided to the FDA on death or serious injuries alleged to have been associated with the use of the products, as well as product malfunctions that would likely cause or contribute to death or serious injury if the malfunction were to recur; and
certain medical devices not cleared with the FDA for marketing in the United States meet specific requirements before they are exported.

European Union

The European Union began to harmonize national regulations comprehensively for the control of medical devices in member nations in 1993, when it adopted its Medical Devices Directive 93/42/EEC. The European Union directive applies to both the manufacturer s quality assurance system and the product s technical design and discusses the various ways to obtain approval of a device (dependent on device classification), how to properly CE Mark a device and how to place a device on the market. We have subjected our entire business in our Target European Market to the most comprehensive procedural approach in order to demonstrate the quality standards and performance of our operations, which we believe is also the fastest way to launch a new product in the European Community.

The regulatory approach necessary to demonstrate to the European Union that the organization has the ability to provide medical devices and related services that consistently meet customer requirements and regulatory requirements applicable to medical devices requires the certification of a full quality management system by a notified body. We engaged TÜV Rheinland of North America, Inc. (TÜV Rheinland) as the notified body to assist us in

obtaining certification to the International Organization for Standardization, or ISO, 13485/2003 standard, which demonstrates the presence of a quality management system that can be used by an organization for design and development, production, installation and servicing of medical devices and the design, development and provision of related services.

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European Union requirements for products are set forth in harmonized European Union standards and include conformity to safety requirements, physical and biological properties, construction and environmental properties, and information supplied by the manufacturer. A company demonstrates conformity to these requirements, with respect to a product, by pre-clinical tests, biocompatibility tests, qualification of products and packaging, risk analysis and well-conducted clinical investigations approved by ethics committees.

Once a manufacturer s full quality management system is determined to be in compliance with ISO 13485/2003 and other statutory requirements, and the manufacturer s products conform with harmonized European standards, the notified body will recommend and document such conformity. The manufacturer will receive a CE marking and ISO certifications, and then may place a CE mark on the relevant products. The CE mark, which stands for Conformité Européenne, demonstrates compliance with the relevant European Union requirements. Products subject to these provisions that do not bear the CE mark cannot be imported to, or sold or distributed within, the European Union.

In July 2003, we received a certification from TÜV Rheinland that our quality management system conforms with the requirements of the European Community. At the same time, TÜV Rheinland approved our use of the CE marking with respect to the design and production of high permeability hemodialyzer products for ESRD therapy. As of the date of this prospectus, the manufacturing facilities and processes that we are using to manufacture our OLpur MDHDF filter series have been inspected and certified by a notified body.

Regulatory Authorities in Regions Outside of the United States and the European Union

We also plan to sell our ESRD therapy products in foreign markets outside the United States which are not part of the European Union. Requirements pertaining to medical devices vary widely from country to country, ranging from no health regulations to detailed submissions such as those required by the FDA. We believe the extent and complexity of regulations for medical devices such as those produced by us are increasing worldwide. We anticipate that this trend will continue and that the cost and time required to obtain approval to market in any given country will increase, with no assurance that such approval will be obtained. Our ability to export into other countries may require compliance with ISO 13485, which is analogous to compliance with the FDA s QSR requirements. In November 2007, the Therapeutic Products Directorate of Health Canada, the Canadian health regulatory agency, approved our OLpur MDHDF filter series for marketing in Canada. Other than the CE marking and Canadian approval of our OLpur MDHDF filter products, we have not obtained any regulatory approvals to sell any of our products and there is no assurance that any such clearance or certification will be issued.

Reimbursement

In both domestic markets and markets outside of the United States, sales of our ESRD therapy products will depend in part, on the availability of reimbursement from third-party payors. In the United States, ESRD providers are reimbursed through Medicare, Medicaid and private insurers. In countries other than the United States, ESRD providers are also reimbursed through governmental and private insurers. In countries other than the United States, the pricing and profitability of our products generally will be subject to government controls. Despite the continually expanding influence of the European Union, national healthcare systems in its member nations, reimbursement decision-making included, are neither regulated nor integrated at the European Union level. Each country has its own system, often closely protected by its corresponding national government.

Product Liability and Insurance

The production, marketing and sale of kidney dialysis products have an inherent risk of liability in the event of product failure or claim of harm caused by product operation. We have acquired product liability insurance for our products in the amount of $5 million. A successful claim in excess of our insurance coverage could materially deplete our assets. Moreover, any claim against us could generate negative publicity, which could decrease the demand for our products, our ability to generate revenues and our profitability.

Some of our existing and potential agreements with manufacturers of our products and components of our products do or may require us (1) to obtain product liability insurance or (2) to indemnify manufacturers against liabilities resulting from the sale of our products. If we are not able to maintain adequate product

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liability insurance, we will be in breach of these agreements, which could materially adversely affect our ability to produce our products. Even if we are able to obtain and maintain product liability insurance, if a successful claim in excess of our insurance coverage is made, then we may have to indemnify some or all of our manufacturers for their losses, which could materially deplete our assets.

Employees

As of December 31, 2010, we employed a total of 8 employees, 6 of whom were full time and 2 who are employed on a part-time basis. We also have engaged 1 consultant on an ongoing basis. Of the 9 total employees and consultants, 2 were employed in a sales/marketing/customer support capacity, 3 in general and administrative and 4 in research and development. Our President and Chief Executive Officer resigned on March 30, 2010, as reported in our Current Report on Form 8-K filed on March 30, 2010. One of our directors has been serving as our acting Chief Executive Officer since April 6, 2010.

Properties

Our U.S. facilities are located at 41 Grand Avenue, River Edge, New Jersey, 07661 and consist of approximately 4,688 square feet of space. The term of the rental agreement is for three years commencing December 2008 with a monthly cost of approximately $7,423. We use our facilities to house our corporate headquarters and research facilities.

Our facilities in our Target European Market are currently located at 6 Eaton House, Main Street, Rathcoole, Co. Dublin, Ireland, and consist of approximately 650 square feet of space. The lease agreement was entered into on November 30, 2008. The lease term is 6 months beginning March 1, 2009 and is renewable for 6 month terms with a 3 month notice to discontinue. Our monthly cost is 735 Euro (approximately $1,000).

We use our facilities to house our accounting, operations and customer service departments. We believe this space will be adequate to meet our needs. We do not own any real property for use in our operations or otherwise.

Legal Proceedings

There are no other currently pending legal proceedings and, as far as we are aware, no governmental authority is contemplating any proceeding to which we are a party or to which any of our properties is subject.

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MANAGEMENT

Board of Directors

Our board of directors is divided into three classes, each class as nearly equal in number as practicable. Our board currently consists of four members. Each year, one class is elected to serve for three years. The business address for each director for matters regarding our company is 41 Grand Avenue, River Edge, New Jersey 07661.

Although our common stock is no longer listed on NYSE Alternext and is traded on Over-the-Counter Bulletin Board, our Board of Directors has determined to apply NYSE Alternext s test for director independence to all of our directors. Using that test, the Board has determined that all of our directors are independent under NYSE Alternext s rules, as of the date of this prospectus, other than Paul A. Mieyal, who began serving as our acting Chief Executive Officer on April 6, 2010. As part of such determination of independence, our Board has affirmatively determined that none of our directors has a relationship with our company that would interfere with the exercise of independent judgment in carrying out his responsibility as a director.

Class I Directors Term Expiring 2011

Name	Age (as of 12/31/10)	Director Since	Business Experience For Last Five Years
Arthur H. Amron	54	2007	Arthur H. Amron has served as a director of our company since September 2007. Mr. Amron is a partner of Wexford Capital LP, a position he has held since 1999, and serves as its General Counsel, a position he has held since joining Wexford in 1994. Mr. Amron also actively participates in various private equity transactions, particularly in the bankruptcy and restructuring areas, and has served on the boards and creditors committees of a number of public and private companies in which Wexford has held investments. From 1991 to 1994, Mr. Amron was an Associate at Schulte Roth & Zabel LLP, specializing in corporate and bankruptcy law, and from 1984 to 1991, Mr. Amron was an Associate at Debevoise & Plimpton LLP specializing in corporate litigation and bankruptcy law. Mr. Amron holds a JD from Harvard University, a BA in political theory from Colgate University and is a member of the New York Bar. Among other experience, qualifications, attributes and skills, Mr. Amron s legal training and experience in the capital markets, as well as his experience serving on boards of directors of other public companies, led to the conclusion of our Board that he should serve as a director of our company in light of our business and structure.

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Name	Age (as of 12/31/10)	Director Since	Business Experience For Last Five Years
James S. Scibetta	45	2007	James S. Scibetta has served as a director of our company since November 2007 and as Chairman of our Board since September 2008. Since August 2008, Mr. Scibetta has been the Chief Financial Officer of Pacira Pharmaceuticals, Inc. Prior to that, Mr. Scibetta was Chief Financial Officer of Bioenvision, Inc. from December 2006 until its acquisition by Genzyme, Inc. in October 2007. From September 2001 to November 2006, Mr. Scibetta was Executive Vice President and CFO of Merrimack Pharmaceuticals, Inc., and he was a member of the Board of Directors of Merrimack from April 1998 to March 2004. Mr. Scibetta formerly served as a senior investment banker at Shattuck Hammond Partners, LLC and PaineWebber Inc., providing capital acquisition, mergers and acquisitions, and strategic advisory services to healthcare companies. From 2001 to 2008, Mr. Scibetta served as a member of the Board of Directors and Audit Committee Chairman of Labopharm, Inc. (Nasdaq: DDSS). Mr. Scibetta holds a B.S. in Physics from Wake Forest University, and an M.B.A. in Finance from the University of Michigan. He completed executive education studies in the Harvard Business School Leadership & Strategy in Pharmaceuticals and Biotechnology program. Among other experience, qualifications, attributes and skills, Mr. Scibetta s extensive management experience in the pharmaceutical industry, as well as his investment banking experience, led to the conclusion of our Board that he should serve as a director of our company in light of our business and structure.

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Class II Director Term Expiring 2012

Name	Age (as of 12/31/10)	Director Since	Business Experience For Last Five Years
Paul A. Mieyal	41	2007	Paul A. Mieyal has served as a director of our company since September 2007 and has served as an acting Chief Executive Officer since April 6, 2010. Dr. Mieyal has been a Vice President of Wexford Capital LP since October 2006. From January 2000 through September 2006, he was Vice President in charge of healthcare investments for Wechsler & Co., Inc., a private investment firm and registered broker-dealer. In his employment with Wexford and Wechsler, Dr. Mieyal has worked closely with both private and public pharmaceutical and other healthcare companies, advising them on regulatory development, corporate and financial matters. Dr. Mieyal is also a director of Nile Therapeutics, Inc., which is a publicly traded companies. Dr. Mieyal received his Ph.D. in pharmacology from New York Medical College, a B.A. in chemistry and psychology from Case Western Reserve University, and is a Chartered Financial Analyst. Since April 6, 2010, Dr. Mieyal has served as our acting Chief Executive Officer. Among other experience, qualifications, attributes and skills, Dr. Mieyal s pharmacology and chemistry education, his experience in investment banking in the healthcare industry, as well as his experience serving on board of directors of another public company, led to the conclusion of our Board that he should serve as a director of our company in light of our business and structure.

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Class III Directors Term Expiring 2013

Name	Age (as of 12/31/10)	Director Since	Business Experience For Last Five Years
Lawrence J. Centella	69	2001	Lawrence J. Centella has served as a director of our company since January 2001. Mr. Centella serves as president of Renal Patient Services, LLC, a company that owns and operates dialysis centers, and has served in such capacity since June 1998. From 1997 to 1998, Mr. Centella served as executive vice president and chief operating officer of Gambro Healthcare, Inc., an integrated dialysis company that manufactured dialysis equipment, supplied dialysis equipment and operated dialysis clinics. From 1993 to 1997, Mr. Centella served as president and chief executive officer of Gambro Healthcare Patient Services, Inc. (formerly REN Corporation). Prior to that, Mr. Centella served as president of COBE Renal Care, Inc., Gambro Hospal, Inc., LADA International, Inc. and Gambro, Inc. Mr. Centella is also the founder of LADA International, Inc. Mr. Centella received a B.S. from DePaul University. Among other experience, qualifications, attributes and skills, Mr. Centella s extensive experience in managing companies engaged in the business of dialysis centers and equipment, led to the conclusion of our Board that he should serve as a director of our company in light of our business and structure.

Executive Officers

The following table sets forth certain information concerning our non-director executive officer:

Name	Age (as of 12/31/10)	Position with Nephros and Business Experience for Last Five Years
Gerald J. Kochanski	57	Gerald J. Kochanski has served as our Chief Financial Officer since April 2008 and served as our acting Chief Executive Officer from March 31 through April 5, 2010. Prior to joining us, Mr. Kochanski served as the Financial Services Director of Lordi Consulting LLC, a national consulting firm, from February 2007 through February 2008. From October 2004 until December 2006, Mr. Kochanski was the Chief Financial Officer of American Water Enterprises, Inc., a business unit of a privately owned company in the water and wastewater treatment industry. From November 1998 through September 2004, Mr. Kochanski was the Chief Financial Officer of Scanvec Amiable Ltd., a publicly traded provider of software to the signmaking, digital printing and engraving industries. Mr. Kochanski is a Certified Public Accountant and received his B.S. in Accounting and his M.B.A. in

Finance from La Salle University.

Beginning on April 6, 2010, our director Paul Mieyal began serving as our acting Chief Executive Officer. Dr. Mieyal does not receive any compensation for his services as our acting Chief Executive Officer.

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EXECUTIVE COMPENSATION

Summary Compensation Table

The following table sets forth all compensation earned in the fiscal years ended December 31, 2010 and 2009 by our Named Executive Officers.

Summary Compensation Table

Name and Principal Position	Year	Salary ($)	Bonus[1] ($)	Option Awards[2] ($)	All Other Compensation[3] ($)	Total
Paul A. Mieyal Acting Chief Executive Officer[4]	2010			$ 14,596	$ 14,800	$ 29,396
Ernest A. Elgin III[5]	2010	$ 66,250			$ 53,507	$ 119,757
President and Chief Executive Officer	2009	$ 240,000		$ 160,048	$ 23,876	$ 423,924
Gerald J. Kochanski	2010	$ 192,143			$ 13,079	$ 205,222
Chief Financial Officer	2009	$ 190,550		$ 48,614	$ 32,059	$ 271,223

(1) The amounts in this column reflect decisions approved by our Compensation Committee and are based on an analysis of the executive s contribution to Nephros during fiscal 2009 and 2010.

(2) The amount reported is the aggregate grant date fair value of the options granted, computed in accordance with FASB ASC Topic 718.

(3) See table below for details on All Other Compensation.

(4) Dr. Mieyal began serving as our acting Chief Executive Officer on April 6, 2010 and receives no compensation for his services, except in his capacity as a director of our company, which compensation is disclosed in the columns titled Option Awards, and All Other Compensation included in this table.

(5) Mr. Elgin became our President and Chief Executive Officer on September 15, 2008 and resigned on March 30, 2010.

All Other Compensation

Option Holdings and Fiscal Year-End Option Values

The following table shows information concerning unexercised options outstanding as of December 31, 2010 for each of our named executive officers.

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Outstanding Equity Awards at Fiscal Year-End 2010

Name	Option Awards Number of Securities Underlying Unexercised Options (#) Exercisable	Number of Securities Underlying Unexercised Options (#) Unexercisable	Option Exercise Price ($)	Option Expiration Date
Paul A. Mieyal	75,000	-0-	$ 0.80	11/30/17
Paul A. Mieyal	6,667	13,333	$ 0.95	1/8/20
Gerald J. Kochanski	125,000	125,000	$ 0.75	4/1/18
Gerald J. Kochanski	6,250	18,750	$ 0.13	1/6/19
Gerald J. Kochanski	18,893	56,677	$ 0.77	12/31/19

Employment and Change in Control Agreements

We have used employment agreements as a means to attract and retain executive officers. These are more fully discussed below. We believe that these agreements provide our executive officers with the assurance that their employment is a long-term arrangement and provide us with the assurance that the officers services will be available to us for the foreseeable future.

Agreement with Mr. Ernest Elgin III

We entered into an employment agreement with Mr. Elgin, dated as of September 15, 2008, having a term of three years. Mr. Elgin resigned on March 30, 2010. As part of his resignation, Mr. Elgin and we mutually agreed to terminate his employment agreement effective March 30, 2010. In connection with Mr. Elgin s resignation, we entered into a separation, release and consulting agreement with him, pursuant to which we paid Mr. Elgin his current salary through April 16, paid his applicable COBRA premiums through April 30, 2010 and, during any time that his COBRA coverage was in effect in 2010, were obligated to reimburse him for out-of-pocket payments made in 2010 under his healthcare coverage up to $5,000, which is the deductible under the healthcare coverage. Mr. Elgin was available to consult with us for up to 15 hours a week until May 31, 2010, for which we paid Mr. Elgin at the rate of 50% of his current salary from April 16 to May 31, 2010. We had the right to extend the consulting period for an additional four months, which we did, during which Mr. Elgin was available to consult with us for up to 7.5 hours a week and during which we paid Mr. Elgin 25% of his current salary. We could terminate this consulting arrangement at any time upon 30 days notice. The agreement terminated pursuant to its terms on September 30, 2010. For his consulting services we paid Mr. Elgin an aggregate of $49,687.

Agreement with Mr. Gerald Kochanski

Mr. Kochanski began serving as our chief financial officer on April 28, 2008, pursuant to an employment agreement dated as of April 1, 2008. Mr. Kochanski s initial annual base salary is $185,000. For the first year of Mr. Kochanski s employment, we will pay him a non-accountable commuting allowance of $10,000. In addition, we agreed to pay up to $10,000 of Mr. Kochanski s moving costs. Mr. Kochanski may be awarded a bonus based on performance. Pursuant to the employment agreement, we granted Mr. Kochanski an option to purchase 250,000 shares of our common stock

under our 2004 Equity Incentive Plan. The option vests in four equal annual installments of 62,500 shares on each of March 31, 2009, March 31, 2010, March 31, 2011 and March 31, 2012 provided that he remains employed by us at such time, and provided further that such options shall become exercisable in full immediately upon the occurrence of a change in control (as defined in our 2004 Stock Incentive Plan).

Mr. Kochanski s agreement provides that upon termination by us for cause or disability (as such terms are defined in the agreement) or by Mr. Kochanski for any reason other than his exercise of the change of control termination option (as defined in the agreement), then we shall pay him only his accrued but unpaid base salary and bonuses for services rendered through the date of termination, his unvested options shall immediately be cancelled and forfeited and his vested options shall remain exercisable for 90 days after such termination. If Mr. Kochanski s employment is terminated by his death or by his voluntary resignation or retirement other than upon his exercise of the change of control termination option, then we shall pay him his

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accrued but unpaid base salary for services rendered through the date of termination and any bonuses due and payable through such date of termination and those that become due and payable within 90 days after such date. If we terminate Mr. Kochanski s employment for any other reason, then, provided he continues to abide by certain confidentiality and non-compete provisions of his agreement and executes a release, he shall be entitled to: (1) any accrued but unpaid base salary for services rendered through the date of termination; and (2) the continued payment of his base salary, in the amount as of the date of termination, for a period of either three months or, if he has been employed under the agreement for at least one year, six months subsequent to the termination date or until the end of the remaining term of the agreement if sooner.

Upon any sale of all or substantially all of our business or assets, whether direct or indirect, by purchase, merger, consolidation or otherwise, Mr. Kochanski shall have a period of time in which to discuss, negotiate and confer with any successor entity regarding the terms and conditions of his continued employment. If Mr. Kochanski, acting reasonably, is unable to timely reach an agreement through good faith negotiations with such successor, then he may elect to terminate his employment with us and receive the payments and bonuses described above with respect to such a termination. This is the same change in control termination option found in the Elgin employment agreement.

The agreement defines cause as (1) conviction of any crime (whether or not involving us) constituting a felony in the jurisdiction involved; (2) engaging in any act which, in each case, subjects, or if generally known would subject, us to public ridicule or embarrassment; (3) gross neglect or misconduct in the performance of the employee s duties under the agreement; or (4) material breach of any provision of the agreement by the employee; provided, however, that with respect to clauses (3) or (4), the employee must have received written notice from us setting forth the alleged act or failure to act constituting cause , and the employee shall not have cured such act or refusal to act within 10 business days of his actual receipt of notice.

The agreement defines disability as our determination that, because of the employee s incapacity due to physical or mental illness, the employee has failed to perform his duties under the agreement on a full time basis for either (1) 120 days within any 365-day period, or (2) 90 consecutive days.

Change in Control Payments

If the change in control payments called for in the agreements for Mr. Kochanski had been triggered on December 31, 2010, we would have been obligated to make the following payments:

Name	Cash Payment Per Month (# of months paid)	Number of Options that Would Vest (Market Value)[1]
Gerald Kochanski	$ 97,180 (6 mos.)	200,428 (-0-)

(1) The market value equals the difference between $0.10, the fair market value of the shares that could be acquired based on the closing sale price per share of our common stock on the Over-the-Counter Bulletin Board on December 31, 2010 and the exercise prices for the underlying stock options. All options have an exercise price in excess of $0.10.

2004 Equity Incentive Plan

The 2004 Plan provides that if there is a change in control, unless the agreement granting an award provides otherwise, all awards under the 2004 Plan will become vested and exercisable as of the effective date of the change in control. As defined in the 2004 Plan, a change in control means the occurrence of any of the following events: (i) any person, including a group, as such terms are defined in sections 13(d) and 14(d) of the Exchange Act and the rules promulgated thereunder, becomes the beneficial owner, directly or indirectly, whether by purchase or acquisition or agreement to act in concert or otherwise, of more than 50% of the outstanding shares of our common stock; (ii) our complete liquidation; (iii) the sale of all or substantially all of our assets; or (iv) a majority of the members of our Board of Directors are elected to the Board without having previously been nominated and approved by a majority of the members of the Board incumbent on the day immediately preceding such election.

As of December 31, 2010, options to purchase 1,046,268 shares had been issued under the 2004 Plan, of which options for 338,646 shares had been exercised and options for 707,622 shares were outstanding, and

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1,650,708 shares remained available for future grants under the 2004 Plan. The Board of Directors and our stockholders, at our annual meeting of stockholders held on January 10, 2011, approved an increase in the number of shares authorized for issuance under the 2004 Plan to 39,814,340 shares.

Director Compensation

In fiscal 2010, our directors received a $10,000 annual retainer, $1,200 per meeting for each quarterly Board meeting attended and reimbursement for expenses incurred m in connection with serving on our Board of Directors. The Chairman of the Board receives an annual retainer of $20,000 and $1,500 per meeting for each quarterly Board meeting attended. The chairperson of our Audit Committee is paid a $5,000 annual retainer and $500 per meeting for meetings of the Audit Committee, with a maximum of eight meetings per year.

We grant each non-employee director who first joins our Board, immediately upon such director s joining our Board, options to purchase 20,000 shares of our common stock in respect of such first year of service at an exercise price per share equal to the fair market value price per share of our common stock on the date of grant. We also grant annually to each non-employee director options to purchase 10,000 shares of our common stock (12,500 shares to the Chairman of the Board) at an exercise price per share equal to the fair market value price per share of our common stock on the grant date, although inadvertently we did not grant these options in 2008 and 2009, and subsequently granted them in January 2010 with an exercise price of $0.95 per share. These non-employee director options vest in three equal installments on each of the date of grant and the first and second anniversaries thereof. Our executive officers do not receive additional compensation for service as directors if any of them so serve.

The following table shows the compensation earned by each of our non-employee directors for the year ended December 31, 2010.

Non-Employee Director Compensation in Fiscal 2010

Name[1]	Fees Earned or Paid in Cash	Option Awards[2]	Total ($)
Arthur H, Amron	$ 14,800	$ 14,596	$ 29,396
Lawrence J. Centella	$ 14,800	$ 14,596	$ 29,396
James S. Scibetta	$ 32,700	$ 16,420	$ 49,120

(1) Paul A. Mieyal, our Acting Chief Executive Officer, is not included in this table as the fees he earned or received as a director in 2010 are disclosed in the column titled All Other Compensation in the Summary Compensation Table on page 93.

(2) The amount reported is the aggregate grant date fair value of the options granted, computed in accordance with FASB ASC Topic 718.

Compensation Committee Interlocks and Insider Participation

Lawrence J. Centella and Paul Mieyal served as members of our Compensation Committee during all of 2010. Mr. Centella was not at any time during 2009 an officer or employee of our company. Paul Mieyal has served as our acting Chief Executive Officer since April 6, 2010. No interlocking relationship exists between any member of our

Compensation Committee and any member of any other company s board of directors or compensation committee.

CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

On October 1, 2010, Lambda Investors loaned us $500,000 pursuant to a secured promissory note. The note bears interest at the rate of 12% per annum and matures on April 1, 2011. The terms of the note are discussed in more detail under the heading The Rights Offering Background of the Rights Offering Loan from Lambda Investors. Lambda Investors also committed to purchase, through a private placement evidenced by a purchase agreement, 60,194,226 Units, which amount equals the number of Units that would otherwise be available for purchase by Lambda Investors pursuant to the exercise of its basic

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subscription privilege, at the rights offering subscription price of $0.02 per Unit, so long as certain conditions are met, including that stockholders not affiliated with Lambda Investors subscribe for at least 87,500,000 of the Units offered in the rights offering. In addition, under the purchase agreement, Lambda Investors has the right to purchase, at the rights offering subscription price, that number of Units that would otherwise be available for purchase by Lambda Investors pursuant to its over-subscription privilege in the event our other stockholders do not exercise their basic subscription privileges in full and Lambda Investors purchases 60,194,266 Units under the purchase agreement. See The Rights Offering Background of the Rights Offering Loan from Lambda Investors and Purchase Agreement with Lambda Investors. Lambda Investors is not receiving any compensation for its purchase commitment. Following the closing of the rights offering, and after giving effect to anti-dilution provisions in existing warrants to purchase shares of our common stock that the rights offering will trigger, Lambda Investors has agreed to surrender for cancellation warrants to purchase a number of shares equal to the total number of shares underlying warrants issued as part of the Units sold in the rights offering and under the purchase agreement with Lambda Investors. The term of the remaining Lambda Investors warrants will be extended so that the warrants will expire at the same time as the warrants issued in the rights offering, which will have a five-year term. We are obligated to use proceeds from the rights offering to repay the $500,000 principal due under the note, plus pay all accrued interest thereon, as well as an 8% sourcing/transaction fee ($40,000) in respect of the note and an aggregate of $100,000 for reimbursement of Lambda Investors legal fees incurred in connection with the loan and the rights offering. The legal fees will be paid upon the closing of the rights offering or, in the case of legal fees relating to the note, upon the maturity of the note, if earlier. See Use of Proceeds. Lambda Investors is our largest stockholder and as of the record date beneficially owned approximately 43.9% of our outstanding common stock, including warrants to purchase an aggregate of 7,190,811 shares of our common stock. Lambda Investors is controlled by Wexford Capital LP. Arthur H. Amron, one of our directors, is a partner and General Counsel of Wexford Capital LP. Paul A. Mieyal, our Acting Chief Executive Officer and one of our directors, is a Vice President of Wexford Capital LP.

In connection with the rights offering, we have agreed to enter into a registration rights agreement with Lambda Investors pursuant to which we will file a registration statement on Form S-1 (or other appropriate form if we are not then eligible to use Form S-3) covering the resale by Lambda Investors of the common stock (including shares issuable upon the exercise of warrants) underlying Units sold under the purchase agreement with Lambda Investors, the existing Lambda Investors warrants that will remain outstanding following the closing of the rights offering and shares of common stock issuable to Lambda Investors upon the exercise of such remaining warrants and warrants issued in the rights offering. Under this registration rights agreement, we will pay all of the expenses, including reasonable legal fees, of Lambda Investors in connection with such registration statement and resale of shares by Lambda Investors under such registration statement, which may be in an underwritten public offering. We will be obligated to use our reasonable best efforts to keep such registration statement continuously effective until such time as all the securities registered on such registration statement have been sold or are eligible for sale without restriction under the applicable securities laws.

In connection with our September 2007 financing, we entered into the registration rights agreement with certain parties, including Lambda Investors, pursuant to which we filed a resale registration statement registering common stock and shares of common stock issuable upon exercise of warrants held by such investors. We agreed to pay all expenses of such investors in connection with such registration statement and the resale of shares thereunder.

In connection with our September 2007 financing, we entered into an investor rights agreement with the 2007 investors pursuant to which we agreed to take such corporate actions as may be required, among other things, to entitle Lambda Investors (i) to nominate two individuals having reasonably appropriate experience and background to our board to serve as directors until their respective successor(s) are elected and qualified, (ii) to nominate each successor to the Lambda Investors nominees, provided that any successor shall have reasonably appropriate experience and background, and (iii) to direct the removal from the board of any director nominated under the

foregoing clauses (i) or (ii). Under the investor rights agreement, we are required to convene meetings of the board of directors at least once every three months. If we fail to do so, a Lambda Investors director will be empowered to convene such meeting.

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The investor rights agreement also provides that, except as Lambda Investors may otherwise agree in writing, Lambda Investors will have the right (i) to engage, directly or indirectly, in the same or similar business activities or lines of business as us and (ii) to do business with any of our clients, competitors or customers, with the result that we shall have no right in or to such activities or any proceeds or benefits therefrom, and neither Lambda Investors nor any officer, director, partner, manager, employee or affiliate of Lambda Investors, which is referred to as a Lambda Investors person, will be liable to us or our stockholders for breach of any fiduciary duty by reason of any such activities of Lambda Investors or of such Lambda Investors person s participation therein. A Lambda Investors person who is serving as one of our officers or directors may not, at the same time, serve as an officer or director of any entity whose principal business activity is (i) the development or sale of medical devices for the treatment of end stage renal disease or (ii) water filtration. In the event that Lambda Investors or any Lambda Investors person acquires knowledge of a potential transaction or matter that may be a corporate opportunity for both Lambda Investors and us other than in the case of a director-related opportunity (as defined below), Lambda Investors and such Lambda Investors person will have no duty to communicate or present such corporate opportunity to us. In addition, in the event that a Lambda Investors director acquires knowledge of a potential transaction or matter that may be a corporate opportunity for both us and Lambda Investors, such corporate opportunity will belong to Lambda Investors, unless such corporate opportunity is a director-related opportunity, in which case such corporate opportunity will belong to us. A director-related opportunity , under the investor rights agreement, means a potential transaction or matter that may be a corporate opportunity for both us and Lambda Investors where knowledge of such corporate opportunity is made known to a Lambda Investors person who is serving as our director as a result of his serving as our director prior to (x) Lambda Investors or any other Lambda Investors person acquiring knowledge of such corporate opportunity, or (y) such Lambda Investors person acquiring knowledge of such corporate opportunity other than as a result of such Lambda Investors person s serving as a director.

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SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The following table sets forth the beneficial ownership of our common stock as of December 31, 2010, by (i) each person known to us to own beneficially more than five percent (5%) of our common stock, based on such persons or entities filings with the SEC as of that date; (ii) each director, director nominee and executive officer; and (iii) all directors, director nominees and executive officers as a group:

Name and Address of Beneficial Owner	Amount and Nature of Beneficial Ownership	Percentage of class[1]
Lambda Investors LLC[2]	21,572,432	43.9 %
Stagg Capital Group LLC[3]	3,749,558	8.9 %
Arthur H. Amron[4]	21,667	*
Lawrence J. Centella[5]	41,667	*
Gerald J. Kochanski[6]	156,393	*
Paul A. Mieyal[7]	21,667	*
James S. Scibetta[8]	40,834	*
All executive officers and directors as a group[4] [8]	282,228	*

* Represents less than 1% of the outstanding shares of our common stock.

(1) Applicable percentage ownership is based on 41,811,048 shares of common stock outstanding as of December 31, 2010, together with applicable options and warrants for each stockholder. Beneficial ownership is determined in accordance with the rules of the SEC, based on factors including voting and investment power with respect to shares. Common stock subject to options and warrants exercisable on or within 60 days after December 31, 2010 are deemed outstanding for the purpose of computing the percentage ownership of the person holding those options or warrants, but not for computing the percentage ownership of any other person.

(2) Based in part on information provided in Schedule 13D/A filed on February 12, 2010. The shares beneficially owned by Lambda Investors may be deemed beneficially owned by Wexford Capital LP, which is the managing member of Lambda Investors, by Charles E. Davidson in his capacity as chairman and managing member of Wexford Capital LP and by Joseph M. Jacobs in his capacity as president and managing member of Wexford Capital LP. The address of each of Lambda Investors LLC, Wexford Capital LP, Mr. Davidson and Mr. Jacobs is c/o Wexford Capital LP, 411 West Putnam Avenue, Greenwich, CT 06830. Each of Wexford Capital LP, Mr. Davidson and Mr. Jacobs disclaims beneficial ownership of the shares of Common Stock owned by Lambda Investors except, in the case of Mr. Davidson and Mr. Jacobs, to the extent of their respective interests in each member of Lambda Investors. Includes 7,190,811 shares issuable on or prior to November 14, 2012 upon exercise of warrants held by Lambda Investors having an exercise price of $0.90 per share. These warrants contain a full-ratchet anti-dilution provision which, provides that if the per share price of the common stock contained in each unit offered by this prospectus is less than the warrant s current exercise price (i) the exercise price of the warrant will be reduced to the per share price of the shares in each unit and (ii) the number of shares covered by the warrant will be increased to an amount derived by multiplying the number of shares covered by the warrant by (x) the per share exercise price in effect before the completion of the offering divided by (y) the new exercise price

(which will be the per share price of each share contained in a unit). Lambda Investors is controlled by Wexford Capital LP. Arthur H. Amron, one of our directors, is a partner and General Counsel of Wexford Capital LP. Paul A. Mieyal, our Acting Chief Executive Officer and one of our directors, is a Vice President of Wexford Capital LP.

(3) Based in part on information provided in Schedule 13D/A filed with the SEC on August 21, 2008. Stagg Capital Group, LLC (Stagg Capital) serves as the investment advisor to an investment fund that holds the shares and Scott A. Stagg is the managing member of Stagg Capital. By reason of such relationships, Stagg Capital and Mr. Stagg may be deemed to be indirect beneficial owners of the shares.

(4) Mr. Amron s address is c/o Wexford Capital LP, 411 West Putnam Avenue, Greenwich, CT 06830. The shares identified as being beneficially owned by Mr. Amron consist of 21,667 shares issuable upon exercise of options granted under the 2004 Plan. Does not include 13,333 shares issuable upon the exercise of options which have been granted under our Stock Option Plans but will not vest within 60 days of December 31, 2010.

(5) Mr. Centella s address is the Company address. The shares identified as being beneficially owned by

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Mr. Centella include 41,667 shares issuable upon exercise of options granted under the 2004 Plan. Does not include 13,333 shares issuable upon the exercise of options which have been granted under our Stock Option Plans but will not vest within 60 days of December 31, 2010.

(6) Mr. Kochanski s address is the Company address. The shares identified as being beneficially owned by Mr. Kochanski consist of 156,393 shares issuable upon exercise of options granted under the 2004 Plan. Does not include 194,177 shares issuable upon the exercise of options which have been granted under our Stock Option Plans but will not vest within 60 days of December 31, 2010.

(7) Mr. Mieyal s address is c/o Wexford Capital LP, 411 West Putnam Avenue, Greenwich, CT 06830. The shares identified as being beneficially owned by Mr. Mieyal consist of 21,667 shares issuable upon exercise of options granted under the 2004 Plan. Does not include13,333 shares issuable upon the exercise of options which have been granted under our Stock Option Plans but will not vest within 60 days of December 31, 2010.

(8) Mr. Scibetta s address is the Company address. The shares identified as being beneficially owned by Mr. Scibetta consist of 40,834 shares issuable upon exercise of options granted under the 2004 Plan. Does not include 21,666 shares issuable upon the exercise of options which have been granted under our Stock Option Plans but will not vest within 60 days of December 31, 2010.

DESCRIPTION OF COMMON STOCK

Our authorized capital stock consists of 90,000,000 shares of common stock, par value $0.001 per share, and 5,000,000 shares of preferred stock, par value $0.001 per share. As of the record date, there were 41,811,048 shares of common stock outstanding and no shares of preferred stock outstanding.

To effect the rights offering we need to increase the number of authorized shares of our common stock. Accordingly, we sought and received the approval of our stockholders at our annual meeting of stockholders held on January 10, 2011, to amend our certificate of incorporation to increase the authorized shares of our capital stock from 95,000,000 to 905,000,000 shares and the authorized shares of our common stock from 90,000,000 to 900,000,000 shares. We intend to file a certificate of amendment to our certificate of incorporation providing for such share increase immediately prior to the closing of the rights offering. Immediately after completion of the rights offering, we intend to effect a 1-for-20 reverse stock split of our outstanding shares of common stock and decrease the authorized shares of our capital stock from 905,000,000 to 95,000,000 shares and the authorized shares of our common stock from 900,000,000 to 90,000,000 shares. We received stockholder approval of such amendment at our annual meeting of stockholders held on January 10, 2011.

If all of the Units offered are sold, we will issue 175,000,000 shares of our common stock in the rights offering and under the purchase agreement with Lambda Investors. Assuming all of the Units offered are sold and no additional shares of our common stock are issued and no outstanding options or warrants are exercised prior to the completion of the rights offering and the private placement of Units with Lambda Investors, approximately 216,811,000 shares of our common stock will be outstanding immediately after the completion of the rights offering and the private placement of Units with Lambda Investors, which will equal approximately 10,840,000 shares after giving effect to our proposed 1-for-20 reverse stock split.

Holders of our common stock are entitled to one vote for each share held of record on all matters submitted to a vote of the stockholders and do not have cumulative voting rights. Accordingly, holders of a majority of the shares of our common stock entitled to vote in any election of directors may elect all of the directors standing for election. Apart from preferences that may be applicable to any holders of preferred stock outstanding at the time, holders of our common stock are entitled to receive dividends, if any, ratably as may be declared from time to time by the Board out of funds legally available therefor. Upon our liquidation, dissolution or winding up, the holders of our common stock are entitled to receive ratably our net assets available after the payment of all liabilities and liquidation preferences on

any outstanding preferred stock. Holders of our common stock have no preemptive, subscription, redemption or conversion rights, and there are no redemption or sinking fund provisions applicable to our common stock. The rights, preferences and privileges of holders of our common stock are subject to, and may be adversely affected by, the rights of the holders of shares of any series of preferred stock which we may designate and issue in the future.

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DESCRIPTION OF WARRANTS

This prospectus also relates to the shares of our common stock issuable upon the exercise, if any, of the warrants issued to the investors in this offering.

The warrants will have an exercise price of $0.02 per share of our common stock and will be exercisable at the option of the holder at any time after the closing date of this offering, through and including the date that is the five year anniversary of the initial exercise date. Notwithstanding the foregoing, no warrants will be exercisable and we will not be obligated to issue any shares issuable upon the exercise of such warrants unless (i) at the time the holder thereof seeks to exercise such warrant, we have a registration statement under the Securities Act in effect covering the shares issuable upon the exercise of such warrant and a current prospectus relating to our common stock, and (ii) the shares issuable upon such exercise have been registered or qualified or deemed to be exempt from registration under the securities laws of the state of residence of the holder of the warrant. The warrants may be exercised only for full shares of common stock, and may not be exercised on a cashless basis. We will not issue fractional shares of common stock or cash in lieu of fractional shares of common stock. Warrant holders do not have any voting or other rights as a stockholder of our company.

If we (i) pay a dividend or make a distribution on our common stock in shares of common stock, other securities, cash or any other property, (ii) subdivide our outstanding shares of common stock into a greater number of shares, (iii) combine or reverse-split our outstanding shares of common stock into a smaller number of shares, or (iv) engage in certain pro-rata repurchases of common stock, then the per share warrant price and the number of warrant shares will be proportionately decreased and increased, respectively, in the case of a subdivision, distribution or stock dividend, or proportionately increased and decreased, respectively, in the case of a combination or reverse stock split. The aggregate warrant price payable for the then total number of warrant shares available for exercise under the warrant will remain the same.

If we effect any capital reorganization or reclassification, or any consolidation or merger, or any sale, transfer or other disposition of all or substantially all of our property, assets or shares to which we are a party, the holder of the warrant will have the right to receive on the exercise of the warrant the kind and amount of securities, cash or other property which the holder would have owned or have been entitled to receive immediately after such reorganization, reclassification, consolidation, merger or reorganization had the warrant been exercised immediately prior to the effective date of such transaction. Our consummation of any such transaction in which we are not the surviving entity will be contingent upon the assumption of the warrants by the surviving party to such transaction.

No market exists for the warrants. We do not intend to list the warrants offered hereby on any securities exchange or automated quotation system.

As of the record date, warrants to purchase 8,191,827 shares of our common stock were outstanding. Upon completion of the rights offering, warrants to purchase 7,519,246 of those shares will become exercisable for an aggregate of 337,108,164 shares at an exercise price of $0.02 per share as a result of the full-ratchet anti-dilution provisions contained in those warrants. Following the closing of the rights offering, and after giving effect to these anti-dilution provisions, Lambda Investors has agreed to surrender for cancellation warrants to purchase 161,793,248 shares of our common stock, which will equal the number of shares underlying warrants issued as part of the Units, assuming all of the Units offered in the rights offering and under the purchase agreement with Lambda Investors are sold. If Lambda Investors purchases 60,194,226 Units under the purchase agreement, it will receive warrants to purchase 55,651,539 shares of our common stock. In addition, following the closing of the rights offering, Lambda Investors existing warrants to purchase 161,793,247 shares that remain outstanding will be amended to expire at the same time as the

warrants issued in the rights offering, which will have a five-year term. Assuming all Units offered in the rights offering and under the purchase agreement with Lambda Investors are sold and after giving effect to the surrender of existing warrants by Lambda Investors, immediately after the closing of the rights offering we will have outstanding warrants to purchase an aggregate of 337,18,164 shares of our common stock at an exercise price of $0.02 per share and warrants to purchase another 672,581 shares of our common stock that will not be affected by the rights offering. After giving effect to the proposed 1-for-20 reverse stock split, we anticipate having outstanding warrants to purchase approximately 16,889,000 shares of our common stock.

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See Certain Relationships and Related Transactions for a description of registration rights with respect to shares of common stock issuable upon exercise of Lambda Investors warrants.

LEGAL MATTERS

The legality of the securities offered hereby will be passed upon for us by Wyrick Robbins Yates & Ponton, LLP, Raleigh, North Carolina.

EXPERTS

Our financial statements at and for the years ended December 31, 2008 and 2009 included in this prospectus have been audited by Rothstein Kass & Company P.C., an independent registered public accounting firm, as stated in their report, which report includes an explanatory paragraph related to the Company s ability to continue as a going concern. Such financial statements have been so incorporated in reliance upon the report of such firm given upon their authority as experts in accounting and auditing.

WHERE YOU CAN FIND MORE INFORMATION

We file annual, quarterly and current reports, proxy statements and other information with the SEC. You may read and copy any document we file at the SEC s public reference room located at 100 F Street, N.E., Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information on the public reference room. Our SEC filings are also available to the public free of charge at the SEC s website at *www.sec.gov* and on our website at *www.nephros.com*.

DISCLOSURE OF SEC POSITION ON INDEMNIFICATION FOR SECURITIES LAW VIOLATIONS

Our Fourth Amended and Restated Certificate of Incorporation, as amended, provides for indemnification of directors and officers of the Registrant to the fullest extent permitted by the Delaware General Corporation Law, or DGCL. We have obtained liability insurance for each director and officer for certain losses arising from claims or charges made against them while acting in their capacities as directors or officers of the registrant. Our Second Amended and Restated By-Laws provide for indemnification of our officers, directors and others who become a party to an action on our behalf by us to the fullest extent not prohibited under the DGCL. However, insofar as indemnification for liabilities arising under the Securities Act may be permitted to our directors, officers, and controlling persons pursuant to the foregoing provisions or otherwise, we have been advised that in the opinion of the SEC such indemnification is against public policy as expressed in the Securities Act and is, therefore, unenforceable. In the event that a claim for indemnification against such liabilities (other than the payment of expenses incurred or paid by a director, officer or controlling person in a successful defense of any action, suit or proceeding) is asserted by such director, officer or controlling person in connection with the securities being registered, we will, unless in the opinion of our counsel the matter has been settled by controlling precedent, submit to the court of appropriate jurisdiction the question whether such indemnification by us is against public policy as expressed in the Securities Act and will be governed by the final adjudication of such issue.

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FINANCIAL STATEMENTS

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Item 8. Financial Statements

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Nephros, Inc.

We have audited the accompanying consolidated balance sheets of Nephros, Inc. and Subsidiary (collectively, the Company) as of December 31, 2009 and 2008, and the related consolidated statements of operations, stockholders equity and cash flows for each of the years then ended. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated 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 audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and 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 Nephros, Inc. and Subsidiary as of December 31, 2009 and 2008, and the results of their operations and their cash flows for each of the years then ended, in conformity with accounting principles generally accepted in the United States of America.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 2 to the consolidated financial statements, the Company has incurred negative cash flow from operations and net losses since inception. These conditions, among others, raise substantial doubt about its ability to continue as a going concern. Management s plans in regard to these matters are also described in Note 2. The accompanying consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ ROTHSTEIN, KASS & COMPANY, P.C.

Roseland, New Jersey
March 31, 2010

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NEPHROS, INC. AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS
(In Thousands, Except Share Amounts)

	December 31, 2009	December 31, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	$1,004	$2,306
Short-term investments		7
Accounts receivable, less allowances of $0 and $4, respectively	629	404
Inventory, less allowances of $18 and $0, respectively	653	724
Prepaid expenses and other current assets	135	162
Total current assets	2,421	3,603
Property and equipment, net	210	412
Other assets	21	21
Total assets	$2,652	$4,036
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$455	$986
Accrued expenses	239	411
Accrued severance expense		105
Total current liabilities	694	1,502
Total liabilities	694	1,502
Commitments and Contingencies (Note 11)		
Stockholders equity:		
Preferred stock, $.001 par value; 5,000,000 shares authorized at December 31, 2009 and 2008; no shares issued and outstanding at December 31, 2009 and 2008		
Common stock, $.001 par value; 90,000,000 and 60,000,000 authorized at December 31, 2009 and 2008, respectively; 41,604,798 and 38,165,380 shares issued and outstanding at December 31, 2009 and 2008, respectively	42	38
Additional paid-in capital	91,815	90,375
Accumulated other comprehensive income	76	70
Accumulated deficit	(89,975)	(87,949)
Total stockholders equity	1,958	2,534
Total liabilities and stockholders equity	$2,652	$4,036

The accompanying notes are an integral part of these consolidated financial statements.

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NEPHROS, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF OPERATIONS
(In Thousands, Except Share and Per Share Amounts)

	Years Ended December 31	
	2009	2008
Product revenue	$ 2,661	$ 1,473
Cost of goods sold	1,744	1,064
Gross margin	917	409
Operating expenses:		
Research and development	280	1,977
Depreciation and amortization	231	447
Selling, general and administrative	2,812	4,702
Total operating expenses	3,323	7,126
Loss from operations	(2,406)	(6,717)
Interest income	9	199
Interest expense	(2)	
Impairment of auction rate securities		(114)
Gain on sale of investments		114
Other income	373	181
Net loss	$ (2,026)	$ (6,337)
Net loss per common share, basic and diluted	$ (0.05)	$ (0.17)
Weighted average common shares outstanding, basic and diluted	39,629,346	38,165,380

The accompanying notes are an integral part of these consolidated financial statements.

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NEPHROS, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY
(In Thousands, Except Share Amounts)

	Common Stock		Additional Paid-in Capital	Accumulated Other Income (Loss)	Accumulated Deficit	Total
	Shares	Amount				
Balance, January 1, 2008	38,165,380	$ 38	$90,220	$ 110	$(81,612)	$8,756
Comprehensive income:						
Net loss					(6,337)	(6,337)
Net unrealized losses on foreign currency translation				(40)		(40)
Comprehensive loss						(6,377)
Noncash stock-based compensation			155			155
Balance, December 31, 2008	38,165,380	$ 38	$90,375	$ 70	$(87,949)	$2,534
Comprehensive income:						
Net loss					(2,026)	(2,026)
Net unrealized gains on foreign currency translation				6		6
Comprehensive loss						(2,020)
Cashless exercise of warrants	1,829,476	2	(2)			
Private placement sale of common stock	1,345,161	1	1,250			1,251
Exercise of stock options	264,781	1	84			85
Noncash stock-based compensation			108			108
Balance, December 31, 2009	41,604,798	$ 42	$91,815	$ 76	$(89,975)	$1,958

The accompanying notes are an integral part of these consolidated financial statements.

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NEPHROS, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS (In Thousands)

	Years Ended December 31,	
	2009	2008
Operating activities:		
Net loss	$ (2,026)	$ (6,337)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation of property and equipment	231	447
Impairment of auction rate securities		114
Noncash stock-based compensation	108	155
Gain on sale of investments		(114)
Inventory reserve	18	
(Increase) decrease in operating assets:		
Accounts receivable	(220)	1
Inventory	57	(409)
Prepaid expenses and other current assets	27	227
Other assets		8
Increase (decrease) in operating liabilities:		
Accounts payable and accrued expenses	(702)	138
Accrued severance expense	(105)	45
Net cash used in operating activities	(2,612)	(5,725)
Investing activities		
Purchase of property and equipment	(28)	(97)
Proceeds from sales of property and equipment		3
Maturities of short-term investments	7	4,693
Net cash provided by (used in) investing activities	(21)	4,599
Financing activities		
Proceeds from stock options exercised	85	
Proceeds from issuance of common stock	1,251	
Net cash provided by financing activities	1,336	
Effect of exchange rates on cash	(5)	(17)
Net decrease in cash	(1,302)	(1,143)
Cash, beginning of year	2,306	3,449
Cash, end of year	$ 1,004	$ 2,306
Supplemental disclosure of cash flow information		
Cash paid for interest	$ 2	$
Cash paid for taxes	$ 6	$ 1

The accompanying notes are an integral part of these consolidated financial statements.

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NEPHROS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Organization and Nature of Operations

Nephros, Inc. (Nephros or the Company) was incorporated under the laws of the State of Delaware on April 3, 1997. Nephros was founded by health professionals, scientists and engineers affiliated with Columbia University to develop advanced End Stage Renal Disease (ESRD) therapy technology and products. The Company has three products in various stages of development in the hemodiafiltration, or HDF, modality to deliver improved therapy for ESRD patients. These are the OLpur™ MDHDF filter series or dialyzers, designed expressly for HDF therapy, the OLpur™ H_2H 2™, an add-on module designed to allow the most common types of hemodialysis machines to be used for HDF therapy, and the OLpur™ NS2000 system, a stand-alone hemodiafiltration machine and associated filter technology. In 2006, the Company introduced its Dual Stage Ultrafilter (DSU) water filter system, which represents a new and complementary product line to the Company s existing ESRD therapy business. The DSU incorporates the Company s unique and proprietary dual stage filter architecture.

On June 4, 2003, Nephros International Limited was incorporated under the laws of Ireland as a wholly-owned subsidiary of the Company. In August 2003, the Company established a European Customer Service and financial operations center in Dublin, Ireland.

Note 2 Summary of Significant Accounting Policies

Principles of Consolidation and Basis of Presentation

The accompanying consolidated financial statements include the accounts of the Company and its wholly owned subsidiary, Nephros International Limited. All intercompany accounts and transactions have been eliminated in consolidation.

These financial statements were approved by management and the Board of Directors and are available for issuance as of the date of the audit opinion. Subsequent events have been evaluated through this date.

Use of Estimates in the Preparation of Financial Statements

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.

Going Concern and Management s Response

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. The Company s recurring losses and difficulty in generating sufficient cash flow to meet its obligations and

sustain its operations raise substantial doubt about its ability to continue as a going concern. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty. Based on the Company s current cash flow projections, it will need to raise additional funds through either the licensing or sale of its technologies or additional public or private offerings of its securities. The Company continues to investigate strategic funding opportunities as they are identified. However, there is no guarantee that the Company will be able to obtain further financing. If it is unable to raise additional funds on a timely basis or at all, the Company would not be able to continue its operations.

The Company has incurred significant losses in its operations in each quarter since inception. For the years ended December 31, 2009 and 2008, the Company has incurred net losses of approximately $2,026,000 and $6,337,000, respectively. In addition, the Company has not generated positive cash flow from operations for the years ended December 31, 2009 and 2008. To become profitable, the Company must increase revenue substantially and achieve and maintain positive gross and operating margins. If the Company is not able to increase revenue and gross and operating margins sufficiently to achieve profitability, the Company s results of operations and financial condition will be materially and adversely affected.

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NEPHROS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 2 Summary of Significant Accounting Policies (continued)

The Company s current operating plans primarily include the continued development and support of the Company s business in the European market, organizational changes necessary to begin the commercialization of the Company s water filtration business and the completion of current year milestones which are included in the Office of Naval Research appropriation.

There can be no assurance that the Company s future cash flow will be sufficient to meet its obligations and commitments. If the Company is unable to generate sufficient cash flow from operations in the future to service its commitments the Company will be required to adopt alternatives, such as seeking to raise debt or equity capital, curtailing its planned activities or ceasing its operations. There can be no assurance that any such actions could be effected on a timely basis or on satisfactory terms or at all, or that these actions would enable the Company to continue to satisfy its capital requirements.

The Company continues to investigate additional funding opportunities. However, there can be no assurance that the Company will be able to obtain further financing, do so on reasonable terms or do so on terms that would not substantially dilute the equity interests in the Company. If the Company is unable to raise additional funds on a timely basis, or at all, the Company will not be able to continue its operations.

Cash and Cash Equivalents

The Company invests its excess cash in bank deposits and money market accounts. The Company considers all highly liquid investments purchased with original maturities of three months or less from the date of purchase to be cash equivalents. Cash equivalents are carried at fair value, which approximate cost, and primarily consist of money market funds maintained at major U.S. financial institutions.

Short-Term Investments

The Company had no short-term investments at December 31, 2009. The Company had $7,000 of short-term investments consisting of a certificate of deposit at December 31, 2008.

See Note 3 for a further discussion of short-term investments as of December 31, 2009 and December 31, 2008.

Accounts Receivable

The Company provides credit terms to customers in connection with purchases of the Company s products. Management periodically reviews customer account activity in order to assess the adequacy of the allowances provided for potential collection issues and returns. Factors considered include economic conditions, each customer s

payment and return history and credit worthiness. Adjustments, if any, are made to reserve balances following the completion of these reviews to reflect management s best estimate of potential losses. The allowance for doubtful accounts at December 31, 2009 and 2008 was $0 and $4,000, respectively. There was no allowance for sales returns at December 31, 2009 or 2008. There were no write offs of accounts receivable to bad debt expense during 2009 or 2008.

Inventory

The Company engages third parties to manufacture and package inventory held for sale, takes title to certain inventory once manufactured, and warehouses such goods until packaged for final distribution and sale. Inventory consists of finished goods and raw materials (fiber) held at the manufacturers facilities, and are valued at the lower of cost or market using the first-in, first-out method.

Patents

The Company has filed numerous patent applications with the United States Patent and Trademark Office and in foreign countries. All costs and direct expenses incurred in connection with patent applications have been expensed as incurred.

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NEPHROS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 2 Summary of Significant Accounting Policies (continued)

Property and Equipment, net

Property and equipment, net is stated at cost less accumulated depreciation. These assets are depreciated over their estimated useful lives of three to seven years using the straight line method.

Impairment for Long-Lived Assets

The Company adheres to ASC Topic 360 and periodically evaluates whether current facts or circumstances indicate that the carrying value of its depreciable assets to be held and used may be recoverable. If such circumstances are determined to exist, an estimate of undiscounted future cash flows produced by the long-lived assets, or the appropriate grouping of assets, is compared to the carrying value to determine whether impairment exists. If an asset is determined to be impaired, the loss is measured based on the difference between the asset s fair value and its carrying value. An estimate of the asset s fair value is based on quoted market prices in active markets, if available. If quoted market prices are not available, the estimate of fair value is based on various valuation techniques, including a discounted value of estimated future cash flows. The Company reports an asset to be disposed of at the lower of its carrying value or its estimated net realizable market value. There were no impairment losses for long-lived assets recorded for the years ended December 31, 2009 and December 31, 2008.

Fair Value of Financial Instruments

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

Revenue Recognition

Revenue is recognized in accordance with ASC Topic 605. Four basic criteria must be met before revenue can be recognized: (i) persuasive evidence of an arrangement exists; (ii) delivery has occurred or services have been rendered; (iii) the fee is fixed or determinable; and (iv) collectability is reasonably assured.

The Company recognizes revenue related to product sales when delivery is confirmed by its external logistics provider and the other criteria of ASC Topic 605 are met. Product revenue is recorded net of returns and allowances. All costs and duties relating to delivery are absorbed by Nephros. All shipments are currently received directly by the Company s customers.

Shipping and Handling Costs

Shipping and handling costs are recorded as cost of goods sold and are approximately $19,000 and $31,000 for the years ended December 31, 2009 and 2008, respectively.

Research and Development Costs

Research and development costs are expensed as incurred.

Stock-Based Compensation

The Company accounts for stock-based compensation in accordance with ASC Topic 718 by recognizing the fair value of stock-based compensation in the statement of operations. The fair value of the Company s stock option awards are estimated using a Black-Scholes option valuation model. This model requires the input of highly subjective assumptions and elections including expected stock price volatility and the estimated life of each award. In addition, the calculation of compensation costs requires that the Company estimate the number of awards that will be forfeited during the vesting period. The fair value of stock-based awards is amortized over the vesting period of the award. For stock-based awards that vest based on performance conditions (e.g. achievement of certain milestones), expense is recognized when it is probable that the condition will be met.

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NEPHROS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 2 Summary of Significant Accounting Policies (continued)

Other Income

Other income in the amount of approximately $373,000 and $181,000 for the years ended December 31, 2009 and December 31, 2008, respectively, resulted primarily from receipt of New York State Qualified Emerging Technology Company (QETC) tax refunds in each of these periods. Tax credits for the years 2006 and 2007 were received and recognized during the year ended December 31, 2009. The tax credit for the year 2005 was received and recognized during the year ended December 31, 2008 and no further tax credits are expected.

Income Taxes

The Company accounts for income taxes in accordance with ASC Topic 740, which requires accounting for deferred income taxes under the asset and liability method. Deferred income taxes are recognized for the tax consequences of temporary differences by applying enacted statutory tax rates applicable in future years to differences between the financial statement carrying amounts and the tax basis of existing assets and liabilities.

For financial reporting purposes, the Company has incurred a loss in each period since its inception. Based on available objective evidence, including the Company s history of losses, management believes it is more likely than not that the net deferred tax assets will not be fully realizable. Accordingly, the Company provided for a full valuation allowance against its net deferred tax assets at December 31, 2009 and December 31, 2008.

ASC Topic 740 prescribes, among other things, a recognition threshold and measurement attributes for the financial statement recognition and measurement of uncertain tax positions taken or expected to be taken in a company s income tax return. ASC 740 utilizes a two-step approach for evaluating uncertain tax positions. Step one or recognition, requires a company to determine if the weight of available evidence indicates a tax position is more likely than not to be sustained upon audit, including resolution of related appeals or litigation processes, if any. Step two or measurement, is based on the largest amount of benefit, which is more likely than not to be realized on settlement with the taxing authority. The Company is subject to income tax examinations by major taxing authorities for all tax years prior to 2006. The adoption of the provisions of ASC 740 did not have a material impact on the Company s consolidated financial statements. During the year ended December 31, 2009 and 2008, the Company recognized no adjustments for uncertain tax positions. However, management s conclusions regarding this policy may be subject to review and adjustment at a later date based on factors including, but not limited to, ongoing analyses of and changes to tax laws, regulation and interpretations, thereof.

Loss per Common Share

In accordance with ACS 260-10, net loss per common share amounts (basic EPS) are computed by dividing net loss attributable to common stockholders by the weighted-average number of common shares outstanding and excluding any potential dilution. Net loss per common share amounts assuming dilution (diluted EPS) is generally computed by reflecting potential dilution from conversion of convertible securities and the exercise of stock options and warrants.

The following securities have been excluded from the dilutive per share computation as they are antidilutive.

	2009	2008
Stock options	1,885,782	2,696,225
Warrants	8,191,827	11,090,248

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NEPHROS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 2 Summary of Significant Accounting Policies (continued)

Foreign Currency Translation

Foreign currency translation is recognized in accordance with ASC Topic 830. The functional currency of Nephros International Limited is the Euro and its translation gains and losses are included in accumulated other comprehensive income. The balance sheet is translated at the year-end rate. The statement of operations is translated at the weighted average rate for the year.

Comprehensive Income (Loss)

Comprehensive income (loss), as defined in ASC 220, is the total of net income (loss) and all other non-owner changes in equity (or other comprehensive income (loss)) such as unrealized gains or losses on securities classified as available-for-sale and foreign currency translation adjustments. For the years ended December 31, 2009 and 2008, the comprehensive loss was approximately $2,020,000 and $6,377,000, respectively.

Recent Issued and Adopted Accounting Standards

Fair Value Measurements In September 2006, the FASB issued guidance regarding fair value measurements. This guidance defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. It applies to other accounting pronouncements where the FASB requires or permits fair value measurements but does not require any new fair value measurements. In February 2008, FASB issued a pronouncement, which delayed the effective date of its prior guidance regarding fair value measurements, specifically for certain non-financial assets and non-financial liabilities to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. The Company adopted the guidance for financial assets and liabilities on January 1, 2008. It did not have any impact on the Company s results of operations or financial position and did not result in any additional disclosures and the Company adopted the guidance for non-financial assets and non-financial liabilities on January 1, 2009, resulting in no impact to the Company s consolidated financial position, results of operations or cash flows.

In April 2009, the FASB issued new accounting guidance on determining fair value when the volume and level of activity for the asset or liability have significantly decreased and identifying transactions that are not orderly. The guidance affirms that the objective of fair value when the market for an asset is not active is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date under current market conditions. It provides guidance for estimating fair value when the volume and level of market activity for an asset or liability have significantly decreased and determining whether a transaction was orderly. It applies to all fair value measurements when appropriate. The adoption of this guidance did not have a significant impact on the Company s consolidated financial position, results of operations or cash flows, or related

footnotes.

In April 2009, the FASB issued new accounting guidance on interim disclosures about fair value of financial instruments, which is effective for the Company for the quarterly period beginning April 1, 2009. The guidance requires an entity to provide the annual disclosures required by a prior pronouncement regarding disclosures about fair value of financial instruments, in its interim financial statements. The application of the guidance did not have a significant impact on the Company s consolidated financial position, results of operations or cash flows, or related footnotes.

In August 2009, the FASB issued an update to provide further guidance on how to measure the fair value of a liability, an area where practitioners have been seeking further guidance. It primarily does three things: 1) sets forth the types of valuation techniques to be used to value a liability when a quoted price in an active market for the identical liability is not available, 2) clarifies that when estimating the fair value of a liability, a reporting entity is not required to include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability and 3) clarifies that both a quoted price in an active market for the identical liability at the measurement date and the quoted price for the identical

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NEPHROS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 2 Summary of Significant Accounting Policies (continued)

liability when traded as an asset in an active market when no adjustments to the quoted price of the asset are required are Level 1 fair value measurements. This standard is effective beginning in the fourth quarter of 2009 for the Company. The adoption of this standard update is not expected to impact the Company s consolidated financial position, results of operations or cash flows.

Business Combinations In December 2007, the FASB issued new accounting guidance on business combinations. The pronouncement establishes principles and requirements for how the acquirer in a business combination recognizes and measures in its financial statements the fair value of identifiable assets acquired, the liabilities assumed and any noncontrolling interest in the acquiree at the acquisition date. The pronouncement determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. It is effective for fiscal years beginning after December 15, 2008. The Company adopted the pronouncement on January 1, 2009 resulting in no impact to the Company s consolidated financial position, results of operations or cash flows.

Subsequent Events On May 28, 2009, the FASB issued guidance regarding subsequent events, which the Company adopted on a prospective basis beginning April 1, 2009. The guidance is intended to establish general standards of accounting and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. It requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for selecting that date. The application of the pronouncement did not have an impact on the Company s consolidated financial position, results of operations or cash flows.

FASB Accounting Standards Codification On June 29, 2009, the FASB issued an accounting pronouncement establishing the FASB Accounting Standards Codification as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities. This pronouncement was effective for financial statements issued for interim and annual periods ending after September 15, 2009, for most entities. On the effective date, all non-SEC accounting and reporting standards will be superseded. The Company adopted this new accounting pronouncement for the quarterly period ended September 30, 2009, as required, and adoption did not have a material impact on the Company s consolidated financial position, results of operations or cash flows.

Recognition and Presentation of Other-Than-Temporary Impairments In April 2009, the FASB issued an accounting pronouncement, which is effective for the Company for interim and annual reporting periods ending after June 15, 2009, that amends existing guidance for determining whether an other than temporary impairment of debt securities has occurred. Among other changes, the FASB replaced the existing requirement that an entity s management assert it has both the intent and ability to hold an impaired security until recovery with a requirement that management assert (a) it does not have the intent to sell the security, and (b) it is more likely than not it will not have to sell the security before recovery of its cost basis. The adoption of this accounting pronouncement did not have an impact on the Company s consolidated financial position, results of operations or cash flows.

New Accounting Pronouncements

In December 2009, the FASB issued ASU No. 2009-17, Consolidations (Topic 810) Improvements to Financial Reporting By Enterprises Involved with Variable Interest Entities (ASU No. 2009-17). ASU 2009-17 requires a qualitative approach for determining the primary beneficiary of a variable interest entity and replaces the quantitative evaluation previously set forth under FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities. This approach is focused on identifying the reporting entity that has the ability to direct the activities of a variable interest entity that most significantly affects the entity s economic performance and has the obligation to absorb the entity s losses or has the right to receive benefits from the entity. ASU No. 2009-17, among other things, will require enhanced disclosures about a reporting entity s involvement in variable interest entities. The guidance under ASU No. 2009-17 will

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 2 Summary of Significant Accounting Policies (continued)

be effective for the first annual period beginning after November 15, 2009, and interim periods within that first annual period. The Company is assessing what impact, if any, adoption of this standard will have on its consolidated financial statements.

Note 3 Short-Term Investments

ASC Topic 820 provides a framework for measuring fair value under generally accepted accounting principles in the United States and requires expanded disclosures regarding fair value measurements. ASC 820 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. ASC 820 also establishes a fair value hierarchy that requires an entity to maximize the use of observable inputs, where available, and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Level 1 Quoted prices in active markets for identical assets or liabilities.

Level 2 Observable inputs, other than Level 1 prices, such as quoted prices in active markets for similar assets and liabilities, quoted prices for identical or similar assets and liabilities in markets that are not active, or other inputs that are observable or can be corroborated by observable market data.

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities, including certain pricing models, discounted cash flow methodologies and similar techniques.

The Company had no financial assets at December 31, 2009.

The following table details the fair value measurements within the fair value hierarchy of the Company s financial assets at December 31, 2008:

	Total Fair Value at December 31, 2008	Fair Value Measurements at Reporting Date Using		
		Level 1	Level 2	Level 3
Certificates of deposit	$ 7,000	$ 7,000	$	$
Total	$ 7,000	$ 7,000	$	$

The following table reflects the activity for the Company s ARS measured at fair value using Level 3 inputs for the year ended December 31, 2008:

	Auction Rate Securities
Balance as of December 31, 2007	$4,700,000
Sale of Securities	(4,700,000)
Gain on sale of investments	114,000
Impairment of auction rate securities	(114,000)
Balance as of December 31, 2008	$

As of December 31, 2008, the Company had grouped certificates of deposit using a Level 1 valuation because market prices are readily available in active markets.

The Company invested in auction rate securities (ARS), which are long-term debt instruments with interest rates reset through periodic short-term auctions. If there are insufficient buyers when such a periodic auction is held, then the auction fails and the holders of the ARS are unable to liquidate their investment through such auction. With the liquidity issues experienced in global credit and capital markets, the ARS held by the Company experienced multiple failed auctions in the first quarter of fiscal year 2008. As a result of the

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NEPHROS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 3 Short-Term Investments (continued)

failed auctions, the Company did not consider the affected ARS liquid and accordingly, the Company classified its ARS as noncurrent assets as of March 31, 2008.

Based upon an analysis of other-than-temporary impairment factors, the Company wrote down ARS with an original par value of $4,400,000 to an estimated fair value of $4,286,000 as of March 31, 2008. The Company reviewed impairments associated with the above in accordance with ASC Topic 320 to determine the classification of the impairment as temporary or other-than-temporary. The Company determined the ARS classification to be other-than-temporary , and charged an impairment loss of $114,000 on the ARS to its results of operations during the three months ended March 31, 2008. Subsequently during the three months ended June 30, 2008, $300,000 of principal on the Company s ARS had been paid back from the debtor. As a result of the payment, the Company s investment decreased from a par value of $4,400,000 to approximately $4,100,000. The net book value of the Company s ARS at June 30, 2008 was $3,986,000. On July 22, 2008, the Company sold its ARS to a third party at 100% of par value, for proceeds of $4,100,000 and as a result, the Company reclassified the ARS from Available-for-Sale to Trading Securities.

In accordance with ASC 320 the ARS, classified as Trading Securities, were valued at their fair value of $4,100,000 at June 30, 2008. The adjustment of the ARS carrying value from $3,986,000 net book value to $4,100,000 fair value resulted in an Unrealized Holding Gain of $114,000 which was recorded in the Company s Consolidated Statement of Operations for the three and six months ended June 30, 2008. As a result of the sale of investment on July 22, 2008, the Company reclassified the unrealized holding gain of $114,000 to a realized gain on sale of investments.

The Company had no investment in Auction Rate Securities during 2009.

Note 4 Inventory

The Company s inventory components as of December 31, 2009 and 2008 were as follows:

	December 31,	
	2009	2008
Raw Materials	$ 257,000	$ 382,000
Finished Goods	414,000	342,000
Total Gross Inventory	671,000	724,000
Less: Inventory reserve	(18,000)	
Total Inventory	$ 653,000	$ 724,000

Note 5 Prepaid Expenses and Other Current Assets

Prepaid expenses and other current assets as of December 31, 2009 and 2008 were as follows:

	December 31,	
	2009	2008
Prepaid insurance premiums	$ 126,000	$ 88,000
Other	9,000	74,000
Prepaid expenses and other current assets	$ 135,000	$ 162,000

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 6 Property and Equipment, Net

Property and equipment as of December 31, 2009 and 2008 was as follows:

	Life	December 31, 2009	2008
Manufacturing equipment	3 5 years	$ 2,115,000	$ 2,057,000
Research equipment	5 years	91,000	91,000
Computer equipment	3 4 years	62,000	61,000
Furniture and fixtures	7 years	39,000	39,000
Property and equipment, gross		2,307,000	2,248,000
Less: accumulated depreciation		2,097,000	1,836,000
Property and equipment, net		$ 210,000	$ 412,000

The Company contracts with a contract manufacturer (CM) to manufacture the Company s ESRD therapy products. The Company owns certain manufacturing equipment located at CM s manufacturing plant.

Depreciation expense for the years ended December 31, 2009 and 2008 was approximately $231,000 and $447,000, respectively, including amortization expense relating to research and development assets.

Note 7 Accrued Expenses

Accrued expenses as of December 31, 2009 and 2008 were as follows:

	December 31, 2009	2008
Accrued Clinical Trial	$	$ 102,000
Accrued Management Bonus and Directors Compensation	97,000	119,000
Accrued Accounting	63,000	75,000
Accrued Legal	19,000	32,000
Accrued Other	60,000	83,000
	$ 239,000	$ 411,000

Note 8 Income Taxes

A reconciliation of the income tax provision computed at the statutory tax rate to the Company s effective tax rate is as follows:

	2009	2008

U.S. federal statutory rate	35.00 %	35.00 %
State & local taxes	5.90 %	10.79 %
Tax on foreign operations	(0.88)%	(1.36)%
State research and development credits	(14.93)%	(2.71)%
Other	0.79 %	(0.32)%
Valuation allowance	(40.81)%	(44.11)%
Effective tax rate	(14.93)%	(2.71)%

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NEPHROS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 8 Income Taxes (continued)

Significant components of the Company s deferred tax assets as of December 31, 2009 and 2008 are as follows:

	2009	2008
Deferred tax assets:		
Net operating loss carry forwards	$ 23,135,000	$ 29,357,000
Research and development credits	974,000	957,000
Nonqualified stock option compensation expense	1,553,000	1,751,000
Other temporary book tax differences	(34,000)	(63,000)
Total deferred tax assets	25,628,000	32,002,000
Valuation allowance for deferred tax assets	(25,628,000)	(32,002,000)
Net deferred tax assets	$	$

A valuation allowance has been recognized to offset the Company s net deferred tax asset as it is more likely than not that such net asset will not be realized. The Company primarily considered its historical loss and potential Internal Revenue Code Section 382 limitations to arrive at its conclusion that a valuation allowance was required.

At December 31, 2009, the Company had Federal, New York State and New York City income tax net operating loss carryforwards of $62,487,000 each and foreign income tax net operating loss carryforwards of $9,273,000. The Company also had Federal research tax credit carryforwards of $974,000 at December 31, 2009 and $957,000 at December 31, 2008. The Federal net operating loss and tax credit carryforwards will expire at various times between 2012 and 2026 unless utilized. During 2009, the Company received $303,000 payroll based research and development credits from New York State.

Implementation of ASC 740 did not result in a cumulative effect adjustment to the accumulated deficit.

It is the Company s policy to report interest and penalties, if any, related to unrecognized tax benefits in income tax expense.

Note 9 Stock Plans, Share-Based Payments and Warrants

Stock Plans

In 2000, the Company adopted the Nephros 2000 Equity Incentive Plan. In January 2003, the Board of Directors adopted an amendment and restatement of the plan and renamed it the Amended and Restated Nephros 2000 Equity Incentive Plan (the 2000 Plan), under which 2,130,750 shares of common stock had been authorized for issuance upon exercise of options granted.

As of December 31, 2008, 220,888 options had been issued to non-employees under the 2000 Plan and were outstanding. Such options expire at various dates through March 15, 2014 all of which are fully vested. As of December 31, 2008, 916,506 options had been issued to employees under the 2000 Plan and were outstanding. Such options expire at various dates between December 31, 2009 and March 15, 2014 all of which are fully vested.

As of December 31, 2009, 41,053 options had been issued to non-employees under the 2000 Plan and were outstanding. Such options expire at various dates through March 15, 2014 all of which are fully vested. As of December 31, 2009, 144,607 options had been issued to employees under the 2000 Plan and were outstanding. Such options expire at various dates between January 22, 2013 and March 15, 2014 all of which are fully vested.

The Board retired the 2000 Plan in June 2004, and thereafter no additional awards may be granted under the 2000 Plan.

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NEPHROS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 9 Stock Plans, Share-Based Payments and Warrants (continued)

In 2004, the Board of Directors adopted and the Company s stockholders approved the Nephros, Inc. 2004 Stock Incentive Plan, and, in June 2005, the Company s stockholders approved an amendment to such plan (as amended, the 2004 Plan), that increased to 800,000 the number of shares of the Company s common stock that are authorized for issuance by the Company pursuant to grants of awards under the 2004 Plan. In May 2007, the Company s stockholders approved an amendment to the 2004 Plan that increased to 1,300,000 the number of shares of the Company s common stock that are authorized for issuance by the Company pursuant to grants of awards under the 2004 Plan. In addition, in June 2008, the Company s stockholders approved an amendment to the 2004 Plan that increased to 2,696,976 the number of shares of the Company s common stock that are authorized for issuance by the Company pursuant to grants of awards under the 2004 Plan.

As of December 31, 2008, 1,366,279 options had been issued to employees under the 2004 Plan and were outstanding. The options expire on various dates between December 14, 2014 and November 8, 2017, and vest upon a combination of the following: immediate vesting or straight line vesting of two or four years. At December 31, 2008, there were 2,050,924 shares available for future grants under the 2004 Plan. As of December 31, 2008, 192,552 options had been issued to non-employees under the 2004 Plan and were outstanding. Such options expire at various dates between November 11, 2014 and November 30, 2017, and vest upon a combination of the following: immediate vesting or straight line vesting of two or four years.

As of December 31, 2009, 1,517,570 options had been issued to employees under the 2004 Plan and were outstanding. The options expire on various dates between January 5, 2016 and December 31, 2019, and vest upon a combination of the following: immediate vesting or straight line vesting of two or four years. At December 31, 2009, there were 1,543,884 shares available for future grants under the 2004 Plan. As of December 31, 2009, 182,552 options had been issued to non-employees under the 2004 Plan and were outstanding. Such options expire at various dates between November 11, 2014 and August 14, 2019, and vest upon a combination of the following: immediate vesting or straight line vesting of two or four years.

Share-Based Payment

Prior to the Company s initial public offering, options were granted to employees, non-employees and non-employee directors at exercise prices which were lower than the fair market value of the Company s stock on the date of grant. After the date of the Company s initial public offering, stock options are granted to employees, non-employees and non-employee directors at exercise prices equal to the fair market value of the Company s stock on the date of grant. Stock options granted have a life of 10 years. Unvested options as of December 31, 2009 currently vest upon a combination of the following: immediate vesting or straight line vesting of two or four years.

Expense is recognized, net of expected forfeitures, over the vesting period of the options. For options that vest upon the achievement of certain milestones, expense is recognized when it is probable that the condition will be met. Stock

based compensation expense recognized for the years ended December 31, 2009 and 2008 was approximately $108,000 or less than $0.01 per share and approximately $155,000 or less than $0.01 per share, respectively.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 9 Stock Plans, Share-Based Payments and Warrants (continued)

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the below assumptions related to risk-free interest rates, expected dividend yield, expected lives and expected stock price volatility.

	Option Pricing Assumptions			
Grant Year	2009		2008	
Stock Price Volatility	93%	96%	89%	90%
Risk-Free Interest Rates	2.51%	3.04%	3.45%	3.47%
Expected Life (in years)	5.75	6.25	6.25	
Expected Dividend Yield	0%		0%	

Expected volatility is based on historical volatility of the Company s common stock at the time of grant. The risk-free interest rate is based on the U.S. Treasury yields in effect at the time of grant for periods corresponding with the expected life of the options. For the expected life, the Company is using the simplified method as described in the SEC Staff Accounting Bulletin 107. This method assumes that stock option grants will be exercised based on the average of the vesting periods and the option s life.

The total fair value of options vested during the fiscal year ended December 31, 2009 was approximately $157,000. The total fair value of options vested during the fiscal year ended December 31, 2008 was approximately $102,000.

The following table summarizes information about stock options outstanding and exercisable at December 31, 2009:

	Options Outstanding			Options Exercisable	
Range of Exercise Price	Number Outstanding as of December 31, 2009	Weighted Average Remaining Contractual Life in Years	Weighted Average Exercise Price	Number Exercisable as of December 31, 2009	Weighted Average Exercise Price
$0.13	108,000	9.0	$ 0.13		$
$0.37	750,000	8.7	$ 0.37	187,500	$ 0.37
$0.75	250,000	8.3	$ 0.75	62,500	$ 0.75
$0.77	354,070	10.0	$ 0.77		$
$0.80 $2.32	166,182	2.2	$ 1.29	137,849	$ 1.27
$2.39 $4.80	257,530	4.1	$ 2.54	247,530	$ 2.54

Total Outstanding	1,885,782	$ 0.85	635,379	$ 1.45

The number of new options granted in 2009 and 2008 is 507,070 and 1,125,000, respectively. The weighted-average fair value of options granted in 2009 and 2008 is $0.69 and $0.38, respectively.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 9 Stock Plans, Share-Based Payments and Warrants (continued)

The following table summarizes the option activity for the years ended December 31, 2009 and 2008:

	Shares	Weighted Average Exercise Price
Outstanding at December 31, 2008	2,696,225	$ 1.10
Options granted	507,070	0.69
Options exercised	(264,780)	0.32
Options forfeited	(1,052,733)	1.56
Outstanding at December 31, 2009	1,885,782	0.85
Expected to vest at December 31, 2009	1,177,880	$ 0.48
Exercisable at December 31, 2009	635,379	$ 1.45

The aggregate intrinsic value of stock options outstanding at December 31, 2009 and the stock options vested or expected to vest is $388,741. A stock option has intrinsic value, at any given time, if and to the extent that the exercise price of such stock option is less than the market price of the underlying common stock at such time. The weighted-average remaining contractual life of options vested or expected to vest is 8.2 years.

As of December 31, 2009, the total remaining unrecognized compensation cost related to non-vested stock options amounted to $456,000 and will be amortized over the weighted-average remaining requisite service period of 2.2 years.

Warrants

Class D Warrants The Company issued Class D Warrants to purchase an aggregate of 9,112,566 shares of the Company s common stock to the Investors upon conversion of the purchased notes. The Company recorded the issuance of the Class D Warrants at their approximate fair market value of $3,763,000. The value of the Class D Warrants was computed using the Black-Scholes option pricing model.

Placement Agent Warrants The Company issued placement agent warrants to purchase an aggregate of 1,756,374 shares of the Company s common stock to the Company s placement agents in connection with their roles in the Company s fall 2007 financing (the 2007 Financing). The Company recorded the issuance of the placement agent warrants at their approximate fair market value of $1,047,000. The value of the placement agent warrants was computed using the Black-Scholes option pricing model.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 9 Stock Plans, Share-Based Payments and Warrants (continued)

The following table summarizes certain terms of all of the Company s outstanding warrants at December 31, 2009 and 2008:

Total Outstanding Warrants at December 31, 2008

Title of Warrant	Date Issued	Expiry Date	Exercise Price	Total Common Shares Issuable	
				2009	2008
IPO Underwriter Warrants	3/24/2005	9/20/2009	$ 7.50		200,000
Lancer Warrants	1/18/2006	1/18/2009	$ 1.50		21,308
Class D Warrants	11/14/2007	11/14/2012	$ 0.706	7,389,565	9,112,566
Placement Agent Warrants	11/14/2007	11/14/2012	$ 0.90	129,681	1,756,374
July 2009 Warrants	7/24/2009	7/24/2014	$ 1.12	672,581	
Total all Outstanding Warrants				8,191,827	11,090,248

(1) Weighted average exercise price is $0.92 and $1.02 for December 31, 2009 and 2008, respectively.

The IPO Underwriter Warrants expired on September 20, 2009.

The Lancer Warrants expired on January 18, 2009.

Issuance of Common Stock due to Class D Warrants Cashless Exercise Provision

The Series D warrants have a cashless exercise provision which states, If, and only if, at the time of exercise pursuant to this Section 1 there is no effective registration statement registering, or no current prospectus available for, the sale of the Warrant Shares to the Holder or the resale of the Warrant Shares by the Holder and the VWAP (as defined below) is greater than the Per Share Exercise Price at the time of exercise, then this Warrant may also be exercised at such time and with respect to such exercise by means of a cashless exercise in which the Holder shall be entitled to receive a certificate for the number of Warrant Shares equal to the quotient obtained by dividing (i) the result of (x) the difference of (A) minus (B), multiplied by (y) (C), by (ii) (A), where:

(A) = the VWAP (as defined below) on the Trading Day (as defined below) immediately preceding the date of such election;

(B) = the Per Share Exercise Price of this Warrant, as adjusted; and

(C) the number of Warrant Shares issuable upon exercise of this Warrant in accordance with the terms of this = Warrant by means of a cash exercise rather than a cashless exercise.

VWAP means, for any date, the price determined by the first of the following clauses that applies: (a) if the Common Stock is then listed or quoted for trading on the New York Stock Exchange, American Stock Exchange, NASDAQ Capital Market, NASDAQ Global Market, NASDAQ Global Select Market or the OTC Bulletin Board, or any successor to any of the foregoing (a Trading Market), the daily volume weighted average price of the Common Stock on the Trading Market on which the Common Stock is then listed or quoted for trading as reported by Bloomberg L.P. for such date if such date is a date on which the Trading Market on which the Common Stock is then listed or quoted for trading (a Trading Day) or the nearest preceding Trading Date (based on a Trading Day from 9:30 a.m. (New York City time) to 4:02 p.m. (New York City time); (b) if the Common Stock is not then listed or quoted for trading on a Trading Market and if prices for the Common Stock are then reported in the Pink Sheets published by Pink Sheets, LLC (or a similar organization or agency succeeding to its functions of reporting prices), the most recent bid price per share of the Common Stock so reported; or (c) in all other cases, the fair market value of a share of Common Stock as determined by an independent appraiser selected in good faith by the Holder and reasonably acceptable to the Company.

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Note 9 Stock Plans, Share-Based Payments and Warrants (continued)

The Company did not have an effective registration statement or a current prospectus available for the sale of the warrant shares to the holder or the resale of the warrant shares by the holder and the VWAP (as defined above) was greater than the per share exercise price from June 8 through August 26, 2009.

A Class D warrant holder elected to exercise 1,723,001 of the 9,112,566 Class D Warrants outstanding as of June 2009 pursuant to the cashless exercise provision of the warrant. As a result, 1,091,222 shares of common stock were issued to this Class D warrant holder in August 2009. The number of shares outstanding in the December 31, 2009 balance sheet and the number of shares outstanding used in the earnings per share calculation for the twelve months ended December 31, 2009 include these shares.

Issuance of Common Stock due to Placement Agent Warrants Cashless Exercise Provision

National Securities Corporation (NSC) and Dinosaur Securities, LLC (Dinosaur and together with NSC, the Placement Agents) acted as co-placement agents in connection with the 2007 Financing pursuant to an Engagement Letter, dated June 6, 2007 and a Placement Agent Agreement dated September 18, 2007. The Placement Agents received (i) an aggregate cash fee equal to 8% of the face amount of the notes purchased in the 2007 Financing (the Purchased Notes) and paid 6.25% to NSC and 1.75% to Dinosaur, and (ii) warrants (Placement Agent Warrant) with a term of five years from the date of issuance to purchase 10% of the aggregate number of shares of the Company s common stock issued upon conversion of the Purchased Notes with an exercise price per share of the Company s common stock equal to $0.706. The Company issued Placement Agents Warrants to purchase an aggregate of 1,756,374 shares of the Company s common stock to the Placement Agent in November 2007 in connection with their roles in the 2007 Financing.

The Placement Agent Warrants have a cashless exercise provision identical to that in the Series D Warrants.

The Company did not have an effective registration statement or a current prospectus available for the sale of the warrant shares to the holders or the resale of the warrant shares by the holders and the VWAP (as defined above) was greater than the per share exercise price from June 8 through August 26, 2009. Several Placement Agents elected to exercise the cashless exercise provision of their warrants.

Placement Agents elected to exercise 1,348,690 of the 1,756,374 Placement Agent Warrants outstanding in June 2009. All elected the Cashless Exercise provision of their warrants. As a result, 594,492 shares of common stock were issued to the Placement Agents in June 2009. The number of shares outstanding in the June 30, 2009 balance sheet and the number of shares outstanding used in the earnings per share calculation for the three and six months ended June 30, 2009 include these shares.

As of June 30, 2009 there were 407,684 Placement Agent Warrants outstanding.

Placement Agents elected to exercise 278,003 of the 407,684 Placement Agent Warrants outstanding in June 2009. All elected the cashless exercise provision of their warrants. As a result, 143,762 shares of common stock were issued to the Placement Agents in the three months ended September 30, 2009. The number of shares outstanding in the September 30, 2009 balance sheet and the number of shares outstanding used in the earnings per share calculation for the three and six months ended September 30, 2009 and for the twelve months ended December 31, 2009 include these shares.

As of December 31, 2009 there were 129,681 Placement Agent Warrants outstanding.

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Note 9 Stock Plans, Share-Based Payments and Warrants (continued)

July 2009 Private Placement

On July 24, 2009, the Company raised gross proceeds of $1,251,000 through the private placement to eight accredited investors of an aggregate of 1,345,161 shares of its common stock and warrants to purchase an aggregate of 672,581 shares of its common stock, representing 50% of the shares of common stock purchased by each investor. The Company sold the shares to investors at a price per share equal to $0.93. The warrants have an exercise price of $1.12, are exercisable immediately and will terminate on July 24, 2014.

Note 10 401(k) Plan

The Company has established a 401(k) deferred contribution retirement plan (the 401(k) Plan) which covers all employees. The 401(k) Plan provides for voluntary employee contributions of up to 15% of annual earnings, as defined. As of January 1, 2004, the Company began matching 100% of the first 3% and 50% of the next 2% of employee earnings to the 401(k) Plan. The Company contributed and expensed $25,000 and $29,000 in 2009 and 2008, respectively.

Note 11 Commitments and Contingencies

Manufacturing and Suppliers

The Company does not intend to manufacture any of its products or components. The Company has entered into an agreement dated May 12, 2003, and amended on March 22, 2005 with a contract manufacturer (CM), a developer and manufacturer of medical products, to assemble and produce the Company s OLpur MD190, MD220 or other filter products at the Company s option. The agreement requires the Company to purchase from CM the OLpur MD190s and MD220s or other filter products that the Company directly markets in Europe, or are marketed by our distributor. In addition, CM will be given first consideration in good faith for the manufacture of OLpur MD190s, MD220s or other filter products that the Company does not directly market. No less than semiannually, CM will provide a report to representatives of both parties to the agreement detailing any technical know-how that CM has developed that would permit them to manufacture the filter products less expensively and both parties will jointly determine the actions to be taken with respect to these findings. If the fiber wastage with respect to the filter products manufactured in any given year exceeds 5%, then CM will reimburse the Company up to half of the cost of the quantity of fiber represented by excess wastage. CM will manufacture the OLpur MD190 or other filter products in accordance with the quality standards outlined in the agreement. Upon recall of any OLpur MD190 or other filter product due to CM having manufactured one or more products that fail to conform to the required specifications or having failed to manufacture one or more products in accordance with any applicable laws, CM will be responsible for the cost of

recall. The agreement also requires that the Company maintain certain minimum product-liability insurance coverage and that the Company indemnify CM against certain liabilities arising out of the Company s products that they manufacture, providing they do not arise out of CM s breach of the agreement, negligence or willful misconduct. The term of the agreement is through May 12, 2010, with successive automatic one-year renewal terms, until either party gives the other notice that it does not wish to renew at least 90 days prior to the end of the term. The agreement may be terminated prior to the end of the term by either party upon the occurrence of certain insolvency-related events or breaches by the other party. Although the Company has no separate agreement with respect to such activities, CM has also been manufacturing the Company s DSU in limited quantities.

The Company entered into an agreement in December 2003, and amended in June 2005, with a fiber supplier (FS), a manufacturer of medical and technical membranes for applications like dialysis, to continue to produce the fiber for the OLpur MDHDF filter series.

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NEPHROS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 11 Commitments and Contingencies (continued)

Pursuant to the agreement, FS is the Company s exclusive provider of the fiber for the OLpur MDHDF filter series in the European Union as well as certain other territories. On January 18, 2010 the FS notified the Company that they are exercising their right to terminate the supply agreement. Termination of the supply agreement will be effective on July 18, 2010. The FS noted their desire to negotiate and execute a new supply agreement with the Company. Negotiations on terms of a new supply agreement are ongoing.

Contractual Obligations

At December 31, 2009, the Company had an operating lease that will expire on November 30, 2011 for the rental of its U.S. office and research and development facilities. The term of the rental agreement is for three years commencing December 2008 with a monthly cost of approximately $7,423.

At December 31, 2009 the Company had an operating lease with a six month term beginning on March 1, 2009 and is renewable for six month terms with a three month notice to discontinue. The monthly cost is 735 Euro (approximately $1,000).

Rent expense for the years ended December 31, 2009 and 2008 totaled $111,000 and $191,000, respectively.

Contractual Obligations and Commercial Commitments

The following tables summarize our approximate minimum contractual obligations and commercial commitments as of December 31, 2009:

	Payments Due in Period				
	Total	Within 1 Year	Years 1 3	Years 3 5	More than 5 Years
Leases	$ 186,000	$ 101,000	$ 85,000	$	$
Employment Contracts	244,000	195,000	49,000		
Total	$ 430,000	$ 296,000	$ 134,000	$	$

Claims

A former employee in France filed a claim in October 2008 stating that the individual is due 30,000 Euro or approximately $42,000 in back wages. The individual left the Company s employment four years ago and signed a Separation Agreement which stated the Company had no further liability to the individual. A final judgment dated October 15, 2009 was issued by a French court whereby the claimant was awarded 11,707 Euro, approximately $18,000. The award was paid in October 2009.

A former employee in the United States filed a claim in March 2009 against the Company and its CEO alleging breach of the individual s employment agreement and fraud. The individual was employed with us from April 2008 through January 8, 2009. The claim was settled as of September 30, 2009 for approximately $11,000. The settlement was paid in October 2009.

A third party has brought a claim against the Company alleging they incurred damages as a result of the Company s cancellation of a transaction in 2008 involving the sale of Auction Rate Securities. A settlement of this claim was reached and paid in March 2010 in the amount of $20,000. The settlement amount has been accrued as of December 2009.

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NEPHROS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 12 Concentration of Credit Risk

Cash and cash equivalents are financial instruments which potentially subject the Company to concentrations of credit risk. The Company deposits its cash in financial institutions. At times, such deposits may be in excess of insured limits. To date, the Company has not experienced any impairment losses on its cash and cash equivalents.

Major Customers

For the year ended December 31, 2009 and 2008, two customers accounted for 87% and 91%, respectively, of the Company s sales. In addition, as of December 31, 2009 and 2008, those customers accounted for 78% and 89%, respectively, of the Company s accounts receivable.

Note 13 Subsequent Event

On March 30, 2010, Ernest Elgin, III resigned as our President and Chief Executive Officer and also resigned from our Board of Directors. In connection with Mr. Elgin s resignation, we entered into a separation, release and consulting agreement with him, pursuant to which we will pay Mr. Elgin his current salary through April 16 and pay his applicable COBRA premiums through April 30, 2010, and, during any time that his COBRA coverage is in effect in 2010, reimburse him for out-of-pocket payments made in 2010 under his healthcare coverage up to $5,000, which is the deductible under the healthcare coverage. Mr. Elgin will be available to consult with us for up to 15 hours a week until May 31, 2010, for which we will pay Mr. Elgin at the rate of 50% of his current salary from April 16 to May 31, 2010. We have the right to extend the consulting period for an additional four months during which Mr. Elgin would be available to consult with us for up to 7.5 hours a week and during which we would pay Mr. Elgin 25% of his current salary. We may terminate this consulting arrangement at any time upon 30 days notice.

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NEPHROS, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except share amounts)

	(Unaudited) September 30, 2010	(Audited) December 31, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	$421	$1,004
Accounts receivable	449	629
Inventory, less allowances of $18	608	653
Prepaid expenses and other current assets	68	135
Total current assets	1,546	2,421
Property and equipment, net	115	210
Other assets	21	21
Total assets	$1,682	$2,652
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$584	$455
Accrued expenses	233	239
Deferred revenue	67	
Total current liabilities	884	694
Total liabilities	884	694
Commitments and Contingencies (Note 11)		
Stockholders equity:		
Preferred stock, $.001 par value; 5,000,000 shares authorized at September 30, 2010 and December 31, 2009; no shares issued and outstanding at September 30, 2010 and December 31, 2009.		
Common stock, $.001 par value; 90,000,000 authorized at September 30, 2010 and December 31, 2009; 41,811,048 and 41,604,798 shares issued and outstanding at September 30, 2010 and December 31, 2009, respectively.	42	42
Additional paid-in capital	91,957	91,815
Accumulated other comprehensive income	42	76
Accumulated deficit	(91,243)	(89,975)
Total stockholders equity	798	1,958
Total liabilities and stockholders equity	$1,682	$2,652

The accompanying notes are an integral part of these unaudited condensed consolidated interim financial statements

NEPHROS, INC. AND SUBSIDIARY CONDENSED CONSOLIDATED BALANCE SHEETS (In thousands, except

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NEPHROS, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except share and per share amounts)
(Unaudited)

	Three Months Ended September 30,		Six Months Ended September 30,	
	2010	2009	2010	2009
Product revenue	$622	$711	$2,421	$1,869
Cost of goods sold	319	463	1,446	1,251
Gross margin	303	248	975	618
Operating expenses:				
Research and development	116	62	259	212
Depreciation	30	53	98	190
Selling, general and administrative	550	676	1,903	2,093
Total operating expenses	696	791	2,260	2,495
Loss from operations	(393)	(543)	(1,285)	(1,877)
Interest income		2	1	8
Interest expense				(2)
Other income	18	146	16	328
Net loss	$(375)	$(395)	$(1,268)	$(1,543)
Net loss per common share, basic and diluted	$(0.01)	$(0.01)	$(0.03)	$(0.04)
Weighted average common shares outstanding, basic and diluted	41,811,048	40,439,506	41,717,781	38,961,179

The accompanying notes are an integral part of these unaudited condensed consolidated interim financial statements

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NEPHROS, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Nine Months Ended September 30,	
	2010	2009
Operating activities:		
Net loss	$ (1,268)	$ (1,543)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation	98	190
Noncash stock-based compensation	70	68
(Increase) decrease in operating assets:		
Accounts receivable	168	(114)
Inventory	28	118
Prepaid expenses and other current assets	67	49
Increase (decrease) in operating liabilities:		
Accounts payable and accrued expenses	129	(638)
Deferred revenue	67	
Net cash used in operating activities	(641)	(1,870)
Investing activities:		
Purchase of property and equipment	(6)	
Maturities of short-term investments		7
Net cash provided by (used in) investing activities	(6)	7
Financing activities:		
Proceeds from private placement		1,251
Proceeds from stock options exercised	72	84
Net cash provided by financing activities	72	1,335
Effect of exchange rates on cash	(8)	17
Net decrease in cash and cash equivalents	(583)	(511)
Cash and cash equivalents, beginning of period	1,004	2,306
Cash and cash equivalents, end of period	$ 421	$ 1,795
Supplemental disclosure of cash flow information:		
Cash paid for interest	$ -	$ 2
Cash paid for taxes	$ 2	$ 6

The accompanying notes are an integral part of these unaudited condensed consolidated interim financial statements

NEPHROS, INC. AND SUBSIDIARY CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (In thou

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NEPHROS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

1. Basis of Presentation and Going Concern

Interim Financial Information

The accompanying unaudited condensed consolidated interim financial statements of Nephros, Inc. and its wholly owned subsidiary, Nephros International, Limited (collectively, the Company), should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company s 2009 Annual Report on Form 10-K filed with the Securities and Exchange Commission (the SEC) on April 2, 2010. The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and in accordance with the instructions to Form 10-Q and Article 8 and Article 10 of Regulation S-X. Accordingly, since they are interim statements, the accompanying consolidated financial statements do not include all of the information and notes required by GAAP for a complete financial statement presentation. The condensed consolidated balance sheet as of December 31, 2009 was derived from the Company s audited consolidated financial statements but does not include all disclosures required by GAAP. In the opinion of management, the interim consolidated financial statements reflect all adjustments consisting of normal, recurring adjustments that are necessary for a fair presentation of the financial position, results of operations and cash flows for the condensed consolidated interim periods presented. Interim results are not necessarily indicative of results for a full year. All significant intercompany transactions and balances have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the Company s consolidated financial statements and accompanying notes. Actual results could differ materially from those estimates.

Going Concern and Management s Response

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. The Company s recurring losses and difficulty in generating sufficient cash flow to meet its obligations and sustain its operations raise substantial doubt about its ability to continue as a going concern. The condensed consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty. Based on the Company s current cash flow projections, it will need to raise additional funds through either the licensing or sale of its technologies or additional public or private offerings of its securities. The Company continues to investigate strategic funding opportunities as they are identified. However, there is no guarantee that the Company will be able to obtain further financing. If it is unable to raise additional funds on a timely basis or at all, the Company would not be able to continue its operations.

The Company has incurred significant losses in its operations in each quarter since inception. For the nine months ended September 30, 2010 and 2009, the Company has incurred net losses of approximately $1,268,000 and $1,543,000, respectively. In addition, the Company has not generated positive cash flow from operations for the three and nine months ended September 30, 2010 and 2009. To become profitable, the Company must increase revenue substantially and achieve and maintain positive gross and operating margins. If the Company is not able to increase revenue and gross and operating margins sufficiently to achieve profitability, the Company s results of operations and financial condition will be materially and adversely affected.

The Company s current operating plans primarily include the continued development and support of the Company s business in the European and Canadian markets, organizational changes necessary to expand the commercialization of the Company s water filtration business and the completion of current year milestones that are included in the Office of Naval Research appropriation.

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NEPHROS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

1. Basis of Presentation and Going Concern (continued)

There can be no assurance that the Company s future cash flow will be sufficient to meet its obligations and commitments. If the Company is unable to generate sufficient cash flow from operations in the future to service its commitments the Company will be required to adopt alternatives, such as seeking to raise debt or equity capital, curtailing its planned activities or ceasing its operations. There can be no assurance that any such actions could be effected on a timely basis or on satisfactory terms or at all, or that these actions would enable the Company to continue to satisfy its capital requirements.

On October 1, 2010, the Company issued a senior secured note to Lambda Investors LLC in the principal amount of $500,000. The Company expects that the proceeds from the note will allow it to fund its operations through March 2011.

The note bears interest at the rate of 12% per annum and matures on April 1, 2011, at which time all principal and accrued interest will be due. However, the Company has agreed to prepay amounts due under the note with the cash proceeds from (a) the planned rights offering, (b) any other equity or debt financing, or (c) the sale of any assets outside the ordinary course of business in each case prior to the maturity date. If the Company does not pay principal and interest under the note when due, the interest rate increases to 16% per annum. The Company may prepay the note without penalty at any time.

The note is secured by a first priority lien on all of the Company s property, including its intellectual property.

As long as indebtedness remains outstanding under the note, the Company will be subject to certain covenants which, among other things, restrict its ability to merge with another company, sell a material amount of its assets, incur any additional indebtedness, repay any existing indebtedness, or declare or pay any dividends in cash, property or securities.

In connection with the note, the Company has agreed to pay Lambda Investors an 8%, or $40,000, sourcing/transaction fee. In addition, the Company will reimburse Lambda Investors legal fees incurred in connection with the note in the amount of $50,000 as well as Lambda Investors legal fees incurred in connection with the rights offering in the amount of $50,000. Those payments will be paid upon the completion of the rights offering or, if earlier, upon the maturity of the note.

Lambda Investors is the Company s largest stockholder and beneficially owns approximately 44% of the Company s outstanding common stock, including warrants to purchase an aggregate of 7,190,811 shares of the Company s common stock. The warrants held by Lambda Investors have an exercise price of $0.90 per share and have full ratchet anti-dilution protection. The shares beneficially owned by Lambda Investors may be deemed beneficially owned by Wexford Capital LP, which is the managing member of Lambda Investors. One of the Company s directors is a partner and general counsel of Wexford Capital. Another of the Company s directors and Acting Chief Executive Officer is a

vice president of Wexford Capital.

The Company, on October 1, 2010, withdrew the Form S-1 that was filed with the Securities and Exchange Commission on May 21, 2010.

On October 1, 2010, the Company filed with the Securities and Exchange Commission a Registration Statement on Form S-1 relating to a proposed rights offering to raise up to $3.5 million from the Company s existing stockholders.

The Company continues to investigate additional funding opportunities. However, there can be no assurance that the Company will be able to obtain further financing, do so on reasonable terms or do so on terms that would not substantially dilute the equity interests in the Company. If the Company is unable to raise additional funds on a timely basis, or at all, the Company will not be able to continue its operations.

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NEPHROS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

2. Concentration of Credit Risk

For the nine months ended September 30, 2010 and 2009, the following customers accounted for the following percentages of the Company s sales, respectively.

Customer	2010		2009	
A	49	%	45	%
B	31	%	42	%
C	6	%	6	%

As of September 30, 2010 and December 31, 2009, the following customers accounted for the following percentages of the Company s accounts receivable, respectively.

Customer	2010		2009	
A	64	%	44	%
B	5	%	34	%
C	11	%	18	%

3. Revenue Recognition

Revenue is recognized in accordance with Accounting Standards Codification (ASC) Topic 605. Four basic criteria must be met before revenue can be recognized: (i) persuasive evidence of an arrangement exists; (ii) delivery has occurred or services have been rendered; (iii) the fee is fixed or determinable; and (iv) collectability is reasonably assured.

The Company recognizes revenue related to product sales when delivery is confirmed by its external logistics provider and the other criteria of ASC Topic 605 are met. Product revenue is recorded net of returns and allowances. All costs and duties relating to delivery are absorbed by the Company. All shipments are currently received directly by the Company s customers.

4. Stock-Based Compensation

The Company accounts for stock-based compensation in accordance with ASC Topic 718 by recognizing the fair value of stock-based compensation in the statement of operations. The fair value of the Company s stock option awards are estimated using a Black-Scholes option valuation model. This model requires the input of highly subjective assumptions and elections including expected stock price volatility and the estimated life of each award. In addition, the calculation of compensation costs requires that the Company estimate the number of awards that will be forfeited during the vesting period. The fair value of stock-based awards is amortized over the vesting period of the award. For

stock-based awards that vest based on performance conditions (e.g. achievement of certain milestones), expense is recognized when it is probable that the condition will be met.

For the three months ended September 30, 2010 and 2009, stock-based compensation expense was approximately $21,000 and $33,000, respectively. For the nine months ended September 30, 2010 and 2009, stock-based compensation expense was approximately $70,000 and $68,000, respectively.

There was no tax benefit related to expense recognized in the three and nine months ended September 30, 2010 and 2009, as the Company is in a net operating loss position. As of September 30, 2010, there was approximately $149,000 of total unrecognized compensation cost related to unvested share-based compensation awards granted under the equity compensation plans which will be amortized over the weighted average remaining requisite service period of 2.2 years. Such amount does not include the effect of future grants of equity compensation, if any. Of the total $149,000, the Company expects to recognize approximately 14% in the remaining interim periods of 2010, approximately 53% in 2011, approximately 20% in 2012 and approximately 13% in 2013.

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NEPHROS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

5. Comprehensive Income (Loss)

Comprehensive income (loss), as defined in ASC Topic 220, is the total of net income (loss) and all other non-owner changes in equity (or other comprehensive income (loss)) such as unrealized gains or losses on securities classified as available-for-sale and foreign currency translation adjustments. As of Septmeber 30, 2010, accumulated other comprehensive loss was approximately $42,000. As of December 31, 2009, accumulated other comprehensive income was approximately $76,000.

6. Loss per Common Share

In accordance with ASC Topic 260-10, net loss per common share amounts (basic EPS) are computed by dividing net loss attributable to common stockholders by the weighted-average number of common shares outstanding and excluding any potential dilution. Net loss per common share amounts assuming dilution (diluted EPS) is generally computed by reflecting potential dilution from conversion of convertible securities and the exercise of stock options and warrants. However, because their effect is antidilutive, the Company has excluded stock options and warrants aggregating 9,085,109 and 9,698,539 shares, respectively, from the computation of diluted EPS for the nine month periods ended September 30, 2010 and 2009, respectively.

7. Recently Adopted Accounting Pronouncements

In December 2009, the Financial Accounting Standards Board (FASB) issued an amendment to ASC Topic 810 Improvements to Financial Reporting By Enterprises Involved with Variable Interest Entities. This amendment to ASC Topic 810 requires a qualitative approach for determining the primary beneficiary of a variable interest entity and replaces the quantitative evaluation previously set forth under FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities. This approach is focused on identifying the reporting entity that has the ability to direct the activities of a variable interest entity that most significantly affects the entity s economic performance and has the obligation to absorb the entity s losses or has the right to receive benefits from the entity. The amendment, among other things, will require enhanced disclosures about a reporting entity s involvement in variable interest entities. The guidance under the amendment to ASC Topic 810 will be effective for the first annual period beginning after November 15, 2009, and interim periods within that first annual period. The Company adopted the pronouncement on January 1, 2010 resulting in no impact to the Company s consolidated financial statements.

In February 2010, the FASB issued an amendment which requires that an SEC filer, as defined, evaluate subsequent events through the date that the financial statements are issued. The update also removed the requirement for an SEC filer to disclose the date through which subsequent events have been evaluated. The adoption of this guidance on January 1, 2010 did not have a material effect on the Company s consolidated financial statements.

In January 2010, the FASB issued an amendment to ASC Topic 820 Improving Disclosures about Fair Value Measurements, which amends the existing fair value measurement and disclosure guidance currently included in ASC Topic 820, Fair Value Measurements and Disclosures, to require additional disclosures regarding fair value measurements. Specifically, the amendment to ASC Topic 820 requires entities to disclose the amounts of significant transfers between Level 1 and Level 2 of the fair value hierarchy and the reasons for these transfers, the reasons for any transfer in or out of Level 3 and information in the reconciliation of recurring Level 3 measurements about purchases, sales, issuances and settlements on a gross basis. In addition, this amendment also clarifies the requirement for entities to disclose information about both the valuation techniques and inputs used in estimating Level 2 and Level 3 fair value measurements. This amendment is effective for interim and annual reporting periods beginning after December 15, 2009, except for additional disclosures related to Level 3 fair value measurements, which are effective for fiscal years beginning after December 15, 2010. The adoption of this amendment did not impact the Company s consolidated financial statements or results of operations.

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NEPHROS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

8. New Accounting Pronouncements

In April 2010, the FASB issued an Accounting Standards Update which provides guidance on defining a milestone and determining when it may be appropriate to apply the milestone method of revenue recognition for research or development transactions. Research or development arrangements frequently include payment provisions whereby a portion or all of the consideration is contingent upon milestone events such as successful completion of phases in a study or achieving a specific result from the research or development efforts. The amendments in this standard provide guidance on the criteria that should be met for determining whether the milestone method of revenue recognition is appropriate. This standard is effective for fiscal years and interim periods within those years beginning on or after June 15, 2010, with early adoption permitted. This standard is effective for the Company on January 1, 2011. The Company is currently evaluating the impact that the adoption of this standard will have on the Company s consolidated financial statements.

9. Fair Value of Financial Instruments

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

The Company had no financial assets held at fair value at September 30, 2010 or December 31, 2009.

10. Inventory, net

Inventory is stated at the lower of cost or market using the first-in first-out method. The Company s inventory as of September 30, 2010 and December 31, 2009 was approximately as follows:

	Unaudited September 30, 2010	Audited December 31, 2009
Raw Materials	$ 152,000	$ 257,000
Finished Goods	474,000	414,000
Total Gross Inventory	$ 626,000	$ 671,000
Less: Inventory reserve	(18,000)	(18,000)
Total Inventory	$ 608,000	$ 653,000

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NEPHROS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

11. Commitments and Contingencies

On March 30, 2010, Ernest Elgin, III resigned as the Company s President and Chief Executive Officer and also resigned from the Board of Directors. In connection with Mr. Elgin s resignation, the Company entered into a separation, release and consulting agreement with Mr. Elgin, pursuant to which the Company paid Mr. Elgin his current salary through April 16, 2010, paid his applicable COBRA premiums through April 30, 2010 and, during any time that his COBRA coverage is in effect in 2010, will reimburse him for out-of-pocket payments made in 2010 under his healthcare coverage up to $5,000, which is the deductible under the healthcare coverage. Mr. Elgin was available to consult with the Company for up to 15 hours a week until May 31, 2010, for which the Company paid Mr. Elgin at the rate of 50% of his current salary from April 16 to May 31, 2010. Mr. Elgin was available to consult with the Company for up to 7.5 hours a week from June 1 to September 30, 2010 for which the Company paid Mr. Elgin at the rate of 25% of his current salary. As of September 30, 2010, the consulting services ceased and there was no remaining unpaid severance balance.

Gerald Kochanski, our Chief Financial Officer, served as the acting Chief Executive Officer from March 30, 2010 until April 5, 2010. As of April 6, 2010, Paul Mieyal, a member of the Board of Directors, has served as the acting Chief Executive Officer. Dr. Mieyal is a Vice President of Wexford Capital LP, the managing member of Lambda Investors LLC, which is the beneficial owner of approximately 44% of the Company s outstanding stock based on common stock and warrants held at September 30, 2010.

Suppliers

The Company entered into an agreement in December 2003, as amended in June 2005, with a fiber supplier (FS), a manufacturer of medical and technical membranes for applications such as dialysis, to continue to produce the fiber for the OLpur MDHDF filter series. Pursuant to the agreement, the FS is the Company s exclusive provider of the fiber for the OLpur MDHDF filter series in the European Union as well as certain other territories. On January 18, 2010 the FS notified the Company that it is exercising its right to terminate the supply agreement. Termination of the supply agreement was effective on July 18, 2010. The FS has continued to sell fiber to the Company while negotiations on terms of a new supply agreement have continued.

12. Subsequent Events

On October 1, 2010, the Company issued a senior secured note to Lambda Investors LLC in the principal amount of $500,000. It is anticipated that the proceeds from the note will fund the Company s operations through March 2011.

The note bears interest at the rate of 12% per annum and matures on April 1, 2011, at which time all principal and accrued interest will be due. However, the Company has agreed to prepay amounts due under the note with the cash proceeds from (a) the planned rights offering, (b) any other equity or debt financing, or (c) the sale of any assets

outside the ordinary course of business in each case prior to the maturity date. If the principal and interest under the note is not paid when due, the interest rate increases to 16% per annum. The note may be prepaid without penalty at any time.

The note is secured by a first priority lien on all of the Company s property, including its intellectual property.

As long as indebtedness remains outstanding under the note, the Company will be subject to certain covenants which, among other things, restrict its ability to merge with another company, sell a material amount of its assets, incur any additional indebtedness, repay any existing indebtedness, or declare or pay any dividends in cash, property or securities.

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NEPHROS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

12. Subsequent Events (continued)

In connection with the note, the Company has agreed to pay Lambda Investors an 8%, or $40,000, sourcing/transaction fee. In addition, the Company will reimburse Lambda Investors legal fees incurred in connection with the note in the amount of $50,000 as well as Lambda Investors legal fees incurred in connection with a proposed rights offering in the amount of $50,000. Those payments will be paid upon the completion of the rights offering or, if earlier, upon the maturity of the note.

Lambda Investors is the Company s largest stockholder and beneficially owns approximately 44% of its outstanding common stock, including warrants to purchase an aggregate of 7,190,811 shares of its common stock. The warrants held by Lambda Investors have an exercise price of $0.90 per share and have full ratchet anti-dilution protection. The shares beneficially owned by Lambda Investors may be deemed beneficially owned by Wexford Capital LP, which is the managing member of Lambda Investors. One of the Company s directors is a partner and general counsel of Wexford Capital. Another of the Company s directors and Acting Chief Executive Officer is a vice president of Wexford Capital.

The Company, on October 1, 2010, withdrew the Form S-1 that was filed with the Securities and Exchange Commission on May 21, 2010.

On October 1, 2010, the Company filed with the Securities and Exchange Commission a Registration Statement on Form S-1 relating to the proposed rights offering to raise up to $3.5 million from its existing stockholders.

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PART II
INFORMATION NOT REQUIRED IN PROSPECTUS

Item 13. Other Expenses of Issuance and Distribution.

The following table sets forth the estimated costs and expenses payable by the registrant in connection with the sale of the securities being registered. All amounts are estimates.

Printing and distribution expenses	$ 16,000
Legal fees and expenses	$ 140,000
Accounting fees and expenses	$ 10,000
Blue Sky fees and expenses	$ 6,000
Subscription and information agent fees	$ 18,000
Miscellaneous	$ 10,000
Total	$ 200,000

Item 14. Indemnification of Directors and Officers.

Section 145 of the Delaware General Corporation Law, or DGCL, permits a corporation, under specified circumstances, to indemnify its directors, officers, employees or agents against expenses (including attorneys fees), judgments, fines and amounts paid in settlements actually and reasonably incurred by them in connection with any action, suit or proceeding brought by third parties by reason of the fact that they were or are directors, officers, employees or agents of the corporation, if such directors, officers, employees or agents acted in good faith and in a manner they reasonably believed to be in or not opposed to the best interests of the corporation and, with respect to any criminal action or proceeding, had no reason to believe their conduct was unlawful. In a derivative action, that is one by or in the right of the corporation, indemnification may be made only for expenses actually and reasonably incurred by directors, officers, employees or agents in connection with the defense or settlement of an action or suit, and only with respect to a matter as to which they will have acted in good faith and in a manner they reasonably believed to be in or not opposed to the best interests of the corporation, except that no indemnification will be made if such person will have been adjudged liable to the corporation, unless and only to the extent that the court in which the action or suit was brought will determine upon application that the defendant directors, officers, employees or agents are fairly and reasonably entitled to indemnity for such expenses despite such adjudication of liability.

Our Fourth Amended and Restated Certificate of Incorporation, as amended, provides for indemnification of our directors and officers of the registrant to the fullest extent permitted by the DGCL. Our Second Amended and Restated By-Laws provides that the we will generally indemnify our directors, officers, employees or agents to the fullest extent permitted by the law against all losses, claims, damages or similar events. We have obtained liability insurance for each director and officer for certain losses arising from claims or charges made against them while acting in their capacities as directors or officers of our company.

Item 15. Recent Sales of Unregistered Securities.

On July 24, 2009, we raised gross proceeds of $1,251,000 through the private placement to eight accredited investors of an aggregate of 1,345,161 shares of our common stock and warrants to purchase an aggregate of 672,581 shares of

our common stock, representing 50% of the shares of common stock purchased by each investor. We sold the shares to investors at a price per share equal to $0.93. The warrants have an exercise price of $1.12, are exercisable immediately and will terminate on July 24, 2014.

In September 2007, we entered into a Subscription Agreement with Lambda Investors LLC, GPC 76, LLC, Lewis P. Schneider and Enso Global Equities Partnership LP (collectively, the New Investors) pursuant to which the New Investors purchased an aggregate of approximately $12.7 million principal amount of Series A 10% Secured Convertible Notes due 2008 (the Purchased Notes) of Nephros, for the face value thereof (the Offering).

Concurrently with the Offering, Nephros entered into an Exchange Agreement with each of Southpaw Credit Opportunity Master Fund LP, 3V Capital Master Fund Ltd, Distressed/High Yield Trading Opportunities, Ltd., Kudu Partners, L.P. and LJHS Company (collectively, the Exchange Investors and

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together with the New Investors, the Investors), pursuant to which the Exchange Investors agreed to exchange the principal and accrued but unpaid interest in an aggregate amount of approximately $5.6 million under the 6% Secured Convertible Notes due 2012 (Old Notes) of Nephros, for new Series B 10% Secured Convertible Notes due 2008 in an aggregate principal amount of $5.3 million (the Exchange Notes).

All principal and accrued but unpaid interest under the New Notes automatically converted into (i) an aggregate of 18,255,128 shares of our common stock, par value $0.001 per share at a conversion price per share equal to $0.706 and (ii) in the case of Purchased Notes, but not Exchange Notes, Class D Warrants to purchase an aggregate of 9,112,566 shares of common stock with an exercise price per share equal to $0.706.

National Securities Corporation, or NSC, and Dinosaur Securities, LLC, or Dinosaur, acted as co-placement agents in connection with the Financing pursuant to an Engagement Letter, dated June 6, 2007 and a Placement Agent Agreement dated September 18, 2007. The co-placement agents received (i) an aggregate cash fee equal to 8% of the face amount of the Purchased Notes, allocated and paid 6.25% to NSC and 1.75% to Dinosaur, and (ii) warrants with a term of five years from the date of issuance to purchase an aggregate of 1,756,374 shares of common stock at an exercise price of $0.706 per share.

Lambda Investors LLC has committed to purchase, through a private placement evidenced by a purchase agreement, 60,194,226 Units, which amount equals the number of Units that would otherwise be available for purchase by Lambda Investors pursuant to the exercise of its basic subscription privilege, at the rights offering subscription price of $0.02 per Unit, so long as certain conditions are met, including that stockholders not affiliated with Lambda Investors subscribe for at least 87,500,000 of the Units offered in the rights offering. In addition, under the purchase agreement, Lambda Investors has the right to purchase, at the rights offering subscription price, that number of Units that would otherwise be available for purchase by Lambda Investors pursuant to its over-subscription privilege in the event our other stockholders do not exercise their basic subscription privileges in full and Lambda Investors purchases 60,194,266 Units under the purchase agreement. Lambda Investors is not receiving any compensation for its purchase commitment.

The sales of the securities described above were not registered under the Securities Act because they were made in transactions exempt from registration under Section 4(2) of the Securities Act.

Item 16. Exhibits

(a) *Exhibits.* The following exhibits are filed as part of this registration statement:

Exhibit No.	Description
3.1	Fourth Amended and Restated Certificate of Incorporation of the Registrant.(5)
3.2	Certificate of Amendment to the Fourth Amended and Restated Certificate of Incorporation of the Registrant.(13)
3.3	Certificate of Amendment to the Fourth Amended and Restated Certificate of Incorporation of the Registrant.(13)
3.4	Certificate of Amendment to the Fourth Amended and Restated Certificate of Incorporation of the Registrant as filed with the Delaware Secretary of State on November 13, 2007.(14)
3.5	Certificate of Amendment to the Fourth Amended and Restated Certificate of Incorporation of the Registrant as filed with the Delaware Secretary of State on October 26, 2009.(24)

3.6	Second Amended and Restated By-Laws of the Registrant.(16)
4.1	Specimen of Common Stock Certificate of the Registrant.(1)
4.2	Form of Underwriter s Warrant.(1)
4.3	Warrant for the purchase of shares of common stock dated January 18, 2006, issued to Marty Steinberg, Esq., as Court-appointed Receiver for Lancer Offshore, Inc.(17)
4.4	Form of Series A 10% Secured Convertible Note due 2008 convertible into Common Stock and Warrants.(15)
4.5	Form of Series B 10% Secured Convertible Note due 2008 convertible into Common Stock.(15)
4.6	Form of Class D Warrant.(15)

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Exhibit No.	Description
4.7	Form of Placement Agent Warrant.(15)
4.8	Form of Investor Warrant issued on July 24, 2009.(20)
4.9	Form of Warrant Certificate.
4.10	Form of Warrant Agreement between the Registrant and Continental Stock Transfer & Trust Company.
4.11	Form of Subscription Rights Certificate.
5.1*	Opinion of Wyrick Robbins Yates & Ponton LLP as to the legality of the securities being registered.
10.1	Amended and Restated 2000 Nephros Equity Incentive Plan.(1)(2)
10.2	2004 Nephros Stock Incentive Plan.(1)(2)
10.3	Amendment No. 1 to 2004 Nephros Stock Incentive Plan.(2)(5)
10.4	Amendment No. 2 to the Nephros, Inc. 2004 Stock Incentive Plan.(14)
10.5	Form of Subscription Agreement dated as of June 1997 between the Registrant and each Purchaser of Series A Convertible Preferred Stock.(1)
10.6	Amendment and Restatement to Registration Rights Agreement, dated as of May 17, 2000 and amended and restated as of June 26, 2003, between the Registrant and the holders of a majority of Registrable Shares (as defined therein).(1)
10.7	Employment Agreement dated as of November 21, 2002 between Norman J. Barta and the Registrant.(1)(2)
10.8	Amendment to Employment Agreement dated as of March 17, 2003 between Norman J. Barta and the Registrant.(1)(2)
10.9	Amendment to Employment Agreement dated as of May 31, 2004 between Norman J. Barta and the Registrant.(1)(2)
10.10	Employment Agreement effective as of July 1, 2007 between Nephros, Inc. and Norman J. Barta.(14)
10.11	Form of Employee Patent and Confidential Information Agreement.(1)
10.12	Form of Employee Confidentiality Agreement.(1)
10.13	Settlement Agreement and Mutual Release dated June 19, 2002 between Plexus Services Corp. and the Registrant.(1)
10.14	Settlement Agreement dated as of January 31, 2003 between Lancer Offshore, Inc. and the Registrant.(1)
10.15	Settlement Agreement dated as of February 13, 2003 between Hermitage Capital Corporation and the Registrant.(1)
10.16	Supply Agreement between Nephros, Inc. and Membrana GmbH, dated as of December 17, 2003.(1)(3)
10.17	Amended Supply Agreement between Nephros, Inc. and Membrana GmbH dated as of June 16, 2005.(3)(7)
10.18	Manufacturing and Supply Agreement between Nephros, Inc. and Medica s.r.l., dated as of May 12, 2003.(1)(3)
10.19	Manufacturing and Supply Agreement between Nephros, Inc. and Medica s.r.l., dated as of March 22, 2005 supercedes prior Agreement dated May 12, 2003.(3)(8)
10.20	HDF-Cartridge License Agreement dated as of March 2, 2005 between Nephros, Inc. and Asahi Kasei Medical Co., Ltd.(4)
10.21	Subscription Agreement dated as of March 2, 2005 between Nephros, Inc. and Asahi Kasei Medical Co., Ltd.(4)

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Exhibit No.	Description
10.22	Non-employee Director Compensation Summary.(2)(6)
10.23	Named Executive Officer Summary of Changes to Compensation.(2)(6)
10.24	Stipulation of Settlement Agreement between Lancer Offshore, Inc. and Nephros, Inc. approved on December 19, 2005.(8)
10.25	Consulting Agreement, dated as of January 11, 2006, between the Company and Bruce Prashker.(2)(8)
10.26	Summary of Changes to Chief Executive Officer s Compensation.(2)(8)
10.27	Offer of Employment Agreement, dated as of February 24, 2006, between the Company and Mark W. Lerner.(2)(8)
10.28	Form of 6% Secured Convertible Note due 2012 for June 1, 2006 Investors.(9)
10.29	Form of Common Stock Purchase Warrant.(9)
10.30	Form of Subscription Agreement, dated as of June 1, 2006.(9)
10.31	Form of Registration Rights Agreement, dated as of June 1, 2006.(9)
10.32	Form of 6% Secured Convertible Note due 2012 for June 30, 2006 Investors.(10)
10.33	Form of Subscription Agreement, dated as of June 30, 2006.(10)
10.34	Employment Agreement between Nephros, Inc. and William J. Fox, entered into on August 2, 2006.(2)(11)
10.35	Addendum to the Commercial Contract between Nephros, Inc. and Bellco S.p.A, effective as of January 1, 2007.(3)(12)
10.36	Form of Subscription Agreement between Nephros and Subscriber.(15)
10.37	Exchange Agreement, dated as of September 19, 2007, between Nephros and the Holders.(15)
10.38	Registration Rights Agreement, dated as of September 19, 2007, among Nephros and the Holders.(15)
10.39	Investor Rights Agreement, dated as of September 19, 2007, among Nephros and the Covered Holders as defined therein.(15)
10.40	Placement Agent Agreement, dated as of September 18, 2007, among Nephros, NSC and Dinosaur.(15)
10.41	License Agreement, dated October 1, 2007, between The Trustees of Columbia University in the City of New York, and Nephros.(17)
10.42	Employment Agreement, dated as of April 1, 2008, between Nephros, Inc. and Gerald Kochanski.(2)(18)
10.43	Separation Agreement and Release, dated as of April 28, 2008, between Nephros, Inc. and Mark W. Lerner.(2)(18)
10.44	Separation Agreement and Release, dated as of September 15, 2008, between Nephros, Inc. and Norman J. Barta.(2)(19)
10.45	Employment Agreement, dated as of September 15, 2008, between Nephros, Inc. and Ernest A. Elgin III.(2)(19)
10.46	Amendment No. 3 to the Nephros, Inc. 2004 Stock Incentive Plan.(20)
10.47	Distribution Agreement between Nephros, Inc. and OLS, dated as of November 26, 2008.
10.48	Lease Agreement between Nephros International LTD and Coldwell Banker Penrose & O Sullivan dated November 30, 2008.
10.49	Distribution Agreement between Nephros, Inc. and Aqua Sciences, Inc., dated as of December 3, 2008.
10.50	Sales Management Agreement between Nephros, Inc. and Steve Adler, dated as of December 16, 2008.

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Exhibit No.	Description
10.51	Form of Subscription Agreement between Nephros, Inc. and various investors, dated July 24, 2009.(21)
10.52	Separation, Release and Consulting Agreement between Nephros, Inc. and Ernest A. Elgin III.(22)
10.53	Consulting Agreement between Nephros, Inc. and John Shallman, dated as of January 2, 2009.(23)
10.54	Authorized Representative Services Agreement between Nephros, Inc. and Donawa Lifescience Consulting Srl, dated as of June 1, 2009.(22)
10.55	Consulting Agreement between Nephros, Inc. and Barry A. Solomon, PhD., dated as of December 8, 2009.(23)
10.56	Senior Secured Note dated October 1, 2010 issued to Lambda Investors LLC.
10.57	Form of Registration Rights Agreement, dated as of , 2010, by and between the Registrant and Lambda Investors LLC.
10.58	Purchase Agreement, dated as of October 1, 2010, by and between the Registrant and Lambda Investors LLC.
21.1	Subsidiaries of Registrant.(12)
23.1*	Consent of Rothstein Kass, Certified Public Accountants.
23.2	Consent of Wyrick Robbins Yates & Ponton LLP (contained in Exhibit 5.1).
24.1	Power of Attorney (included on the signature page).
99.1	Form of Instructions for Use of Subscription Certificates.
99.2	Form of Notice of Guaranteed Delivery.
99.3	Form of Letter to Stockholders from the Company.
99.4	Form of Letter to Nominee Holders whose Clients are Beneficial Holders.
99.5	Form of Letter to Clients of Nominee Holders.
99.6	Form of Nominee Holder Certification.
99.7	Form of Beneficial Owner Election.

* Filed herewith.

Previously filed.

(1) Incorporated by reference to Nephros, Inc. s Registration Statement on Form S-1, File No. 333-116162.

(2) Management contract or compensatory plan arrangement.

(3) Portions omitted pursuant to a request for confidential treatment.

(4) Incorporated by reference to Nephros, Inc. s Current Report on Form 8-K Filed with the Securities and Exchange Commission on March 3, 2005.

(5) Incorporated by reference to Nephros, Inc. s Registration Statement on Form S-8 (No. 333-127264), as filed with the Securities and Exchange Commission on August 5, 2005.

(6) Incorporated by reference to Nephros, Inc. s Quarterly Report on Form 10-QSB, filed with the Securities and Exchange Commission on May 16, 2005.

(7) Incorporated by reference to Nephros, Inc. s Quarterly Report on Form 10-QSB, filed with the Securities and Exchange Commission on August 15, 2005.

(8) Incorporated by reference to Nephros, Inc. s Annual Report on Form 10-KSB, filed with the Securities and Exchange Commission on April 20, 2006.

(9) Incorporated by reference to Nephros, Inc. s Current Report on Form 8-K filed with the Securities and Exchange Commission on June 2, 2006.

(10)

Incorporated by reference to Nephros, Inc. s Current Report on Form 8-K filed with the Securities and Exchange Commission on July 7, 2006.

(11) Incorporated by reference to Nephros, Inc. s Current Report on Form 8-K filed with the Securities and Exchange Commission on August 4, 2006.

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(12) Incorporated by reference to Nephros, Inc. s Annual Report on Form 10-KSB for the year ended December 31, 2006, filed with the Securities and Exchange Commission on April 10, 2007.

(13) Incorporated by reference to Nephros, Inc. s Quarterly Report on Form 10-QSB for the quarter ended June 30, 2007, filed with the Securities and Exchange Commission on August 13, 2007.

(14) Incorporated by reference to Nephros, Inc. s Quarterly Report on Form 10-QSB for the quarter ended September 30, 2007, filed with the Securities and Exchange Commission on November 13, 2007.

(15) Incorporated by reference to Nephros, Inc. s Current Report on Form 8-K filed with the Securities and Exchange Commission on September 25, 2007.

(16) Incorporated by reference to Nephros, Inc. s Current Report on Form 8-K filed with the Securities and Exchange Commission on December 3, 2007.

(17) Incorporated by reference to Nephros, Inc. s Annual Report on Form 10-KSB for the year ended December 31, 2007, filed with the Securities and Exchange Commission on March 31, 2008.

(18) Incorporated by reference to Nephros, Inc. s Quarterly Report on Form 10-Q for the quarter ended March 31, 2008, filed with the Securities and Exchange Commission on May 15, 2008.

(19) Incorporated by reference to Nephros, Inc. s Quarterly Report on Form 10-Q for the quarter ended September 30, 2008, filed with the Securities and Exchange Commission on November 14, 2008.

(20) Incorporated by reference to Nephros, Inc. s Annual Report on Form 10-K for the year ended December 31, 2008, filed with the Securities and Exchange Commission on March 31, 2009.

(21) Incorporated by reference to Nephros, Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 2009, filed with the Securities and Exchange Commission on August 14, 2009.

(22) Incorporated by reference to Nephros, Inc. s Current Report on Form 8-K filed with the Securities and Exchange Commission on March 30, 2010.

(23) Incorporated by reference to Nephros, Inc. s Annual Report on Form 10-K for the year ended December 31, 2009, filed with the Securities and Exchange Commission on April 2, 2010.

(24) Incorporated by reference to Nephros, Inc. s Registration Statement on Form S-1, File No. 333-162781.

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Item 17. Undertakings.

(a) The undersigned registrant hereby undertakes:

(1) To file, during any period in which offers or sales are being made, a post-effective amendment to this registration statement:

(i) To include any prospectus required by Section 10(a)(3) of the Securities Act of 1933 (the Act);

(ii) To reflect in the prospectus any facts or events arising after the effective date of this registration statement (or the most recent post-effective amendment thereof) which, individually or in the aggregate, represent a fundamental change in the information in the registration statement. Notwithstanding the foregoing, any increase or decrease in volume of securities offered (if the total dollar value of securities offered would not exceed that which was registered) and any deviation from the low or high end of the estimated maximum offering range may be reflected in the form of prospectus filed with the Commission pursuant to Rule 424(b) if, in the aggregate, the changes in volume and price represent no more than a 20% change in the maximum aggregate offering price set forth in the Calculation of Registration Fee table in the effective registration statement; and

(iii) To include any material information with respect to the plan of distribution not previously disclosed in this registration statement or any material change to such information in this registration statement.

(2) That, for the purpose of determining any liability under the Act, each such post-effective amendment shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof.

(3) To remove from registration by means of a post-effective amendment any of the securities being registered which remain unsold at the termination of the offering.

(5) That, for the purpose of determining liability under the Act to any purchaser, each prospectus filed pursuant to Rule 424(b) as part of a registration statement relating to an offering, other than registration statements relying on Rule 430B or other than prospectuses filed in reliance on Rule 430A, shall be deemed to be part of and included in the registration statement as of the date it is first used after effectiveness. Provided, however, that no statement made in a registration statement or prospectus that is part of the registration statement or made in a document incorporated or deemed incorporated by reference into the registration statement or prospectus that is a part of the registration statement will, as to a purchaser with a time of contract of sale prior to such first use, superseded or modify any statement that was made in the registration statement or prospectus that was part of the registration statement or made in any such document immediately prior to such date of first use.

(6) That, for the purpose of determining liability of the registrant under the Act to any purchaser in the initial distribution of the securities, the undersigned registrant undertakes that in a primary offering of securities of the undersigned registrant pursuant to this registration statement, regardless of the underwriting method used to sell the securities to the purchaser, if the securities are offered or sold to such purchaser by means of any of the following communications, the undersigned registrant will be a seller to the purchaser and will be considered to offer or sell such securities to such purchaser:

(i) Any preliminary prospectus or prospectus of an undersigned registrant relating to this offering required to be filed pursuant to Rule 424;

(ii) Any free writing prospectus relating to this offering prepared by, or on behalf of, the undersigned registrant or used or referred to by the undersigned registrant;

(iii)

The portion of any other free writing prospectus relating to this offering containing material information about an undersigned registrant or its securities provided by or on behalf of the undersigned registrant; and

(iv) Any other communication that is an offer in this offering made by the undersigned registrant to the purchaser.

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(c) The undersigned registrant hereby undertakes to supplement the prospectus, after the expiration of the subscription period, to set forth the results of the subscription offer and the amount of unsubscribed securities to be offered to the public. If any public offering of the securities is to be made on terms differing from those set forth on the cover page of the prospectus, a post-effective amendment will be filed to set forth the terms of such offering.

(h) Insofar as indemnification for liabilities arising under the Act may be permitted to directors, officers and controlling persons of the registrant pursuant to the foregoing provisions, or otherwise, the registrant has been advised that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Act and is, therefore, unenforceable. In the event that a claim for indemnification against such liabilities (other than the payment by the registrant of expenses incurred or paid by a director, officer or controlling person of the registrant in the successful defense of any action, suit or proceeding) is asserted by such director, officer or controlling person in connection with the securities being registered, the registrant will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction the question whether such indemnification by it is against public policy as expressed in the Act and will be governed by the final adjudication of such issue.

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SIGNATURES

Pursuant to the requirements of the Securities Act of 1933, the registrant has duly caused this registration statement to be signed on its behalf by the undersigned, thereunto duly authorized in the City of River Edge, State of New Jersey, on January 27, 2011.

NEPHROS, INC.
By:

Date: January 27, 2011

/s/ Paul A. Mieyal
Name: Paul A. Mieyal
Title: Acting Chief Executive Officer and Director

Pursuant to the requirements of the Securities Act of 1933, this registration statement has been signed by the following persons in the capacities and on the dates indicated.

Signature	Title	Date
/s/ Paul A. Mieyal Paul A. Mieyal	Acting Chief Executive Officer (Principal Executive Officer) and Director	January 27, 2011
/s/ Gerald J. Kochanski Gerald J. Kochanski	Chief Financial Officer (Principal Financial and Accounting Officer)	January 27, 2011
/s/ Arthur H. Amron Arthur H. Amron	Director	January 27, 2011
/s/ Lawrence J. Centella Lawrence J. Centella	Director	January 27, 2011
/s/ James S. Scibetta* James S. Scibetta	Director	January 27, 2011

*By:

/s/ Gerald J. Kochanski
Gerald J. Kochanski
Attorney-in-Fact