ARBIOS SYSTEMS INC
Form 10-Q
November 14, 2008

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

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**FORM 10-Q**

(MARK ONE)

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

For the quarterly period ended September 30, 2008

o TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT

For the transition period from _____ to _____

Commission file number: 000-32603

**ARBIOS SYSTEMS, INC**.
(Exact name of registrant as specified in its charter)

| Delaware | 91-1955323 |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| 200 E. Del Mar Blvd., Suite 320, Pasadena, CA | 91105 |
| (Address of principal executive offices) | (Zip Code) |

(626) 356-3105
(Registrant's telephone number, including area code)

1050 Winter Street, #1000
Waltham, MA 02451
(Former name or former address, if changed since last report)

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Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.
Yes x No ¨

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

| Large Accelerated filer o | Accelerated filer o |
|---|---|

Non-accelerated filer o Smaller reporting company x
(do not check if a smaller reporting company)

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

On September 30, 2008, there were 25,792,747 shares of common stock, $.001 par value per share, issued and outstanding.

**ARBIOS SYSTEMS, INC.**
**FORM 10-Q**
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## PART I - FINANCIAL INFORMATION

### ITEM 1. Condensed Financial Statements

**ARBIOS SYSTEMS, INC.**
(A development stage company)
**CONDENSED BALANCE SHEETS**

| | September 30, 2008 (Unaudited) | December 31, 2007 |
|---|---|---|
| **ASSETS** | | |
| Current assets | | |
| Cash and cash equivalents | $ 477,756 | $ 2,735,944 |
| Prepaid expenses | 2,087 | 37,546 |
| Total current assets | 479,843 | 2,773,490 |
| Net property and equipment | 22,240 | 45,450 |
| Assets held for sale | 116,931 | 132,293 |
| Deferred financing costs | - | 16,757 |
| Other assets | 1,550 | 70,236 |
| Total assets | $ 620,564 | $ 3,038,226 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)** | | |
| Current liabilities | | |
| Accounts payable | $ 320,578 | $ 434,727 |
| Accrued expenses | 386,250 | 483,617 |
| Total current liabilities | 706,828 | 918,344 |
| Long term contract obligations | 150,000 | 250,000 |
| Total liabilities | 856,828 | 1,168,344 |
| Stockholders' equity (deficit) | | |
| Preferred stock, $.001 par value; 5,000,000 shares authorized: | | |
| none issued and outstanding | - | - |
| Common stock, $.001 par value; 100,000,000 shares authorized; 25,792,747 and 25,578,461 shares issued and outstanding at September 30, 2008 and December 31, 2007, respectively | 25,792 | 25,578 |
| Additional paid-in capital | 21,600,117 | 21,159,276 |
| Deficit accumulated during the development stage | (21,862,173) | (19,314,972) |
| Total stockholders' equity (deficit) | (236,264) | 1,869,882 |
| Total liabilities and stockholders' equity (deficit) | $ 620,564 | $ 3,038,226 |

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

**ARBIOS SYSTEMS, INC.**
(A development stage company)
**CONDENSED STATEMENTS OF OPERATIONS**
(Unaudited)

| | For the three months ended September 30, | | For the nine months ended September 30, | | August 23, 2000 (inception) through September 30, 2008 |
|---|---|---|---|---|---|
| | 2008 | 2007 | 2008 | 2007 | |
| Revenues | $ - | $ - | $ - | $ - | $ 320,966 |
| Operating expenses: | | | | | |
| General and administrative | 147,103 | 1,025,108 | 1,358,718 | 2,651,264 | 13,100,855 |
| Research and development | 164,350 | 422,743 | 1,220,747 | 1,982,747 | 9,333,555 |
| Total operating expenses | 311,453 | 1,447,851 | 2,579,465 | 4,634,011 | 22,434,410 |
| Loss before other income (expense) | (311,453) | (1,447,851) | (2,579,465) | (4,634,011) | (22,113,444) |
| Other income (expense): | | | | | |
| Interest income | 3,786 | 53,445 | 32,264 | 128,064 | 495,409 |
| Interest expense | - | - | - | - | (244,138) |
| Total other income (expense) | 3,786 | 53,445 | 32,264 | 128,064 | 251,271 |
| Net loss | $ (307,667) | $ (1,394,406) | $ (2,547,201) | $ (4,505,947) | $ (21,862,173) |
| Net loss per share: | | | | | |
| Basic and diluted | $ (0.01) | $ (0.05) | $ (0.10) | $ (0.20) | |
| Weighted-average shares: | | | | | |
| Basic and diluted | 25,792,747 | 25,446,803 | 25,712,950 | 22,021,676 | |

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

**ARBIOS SYSTEMS, INC.**
(A Development Stage Company)
**CONDENSED STATEMENTS OF CASH FLOWS**
(Unaudited)

| | For the nine months ended September 30, | | August 23, 2000 (inception) |
|---|---|---|---|
| | 2008 | 2007 | through September 30, 2008 |
| **Cash flows from operating activities:** | | | |
| Net loss | $ (2,547,201) | $ (4,505,947) | $ (21,862,173) |
| | | | |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: | | | |
| Amortization of debt discount | - | - | 244,795 |
| Depreciation and amortization | 32,190 | 37,506 | 334,454 |
| Patent rights impairment | - | - | 91,694 |
| Issuance of common stock, options and warrants for compensation | 441,055 | 585,376 | 4,054,502 |
| Issuance of warrants for patent acquistion | - | 74,570 | 74,570 |
| Settlement of accrued expense | - | - | 54,401 |
| Deferred compensation costs | - | - | 319,553 |
| Loss on disposition of fixed assets | 2,207 | 2,766 | 4,973 |
| Changes in operating assets and liabilities: | | | |
| Prepaid expenses | 35,459 | 96,388 | (2,089) |
| Deferred financing costs | 16,757 | - | - |
| Other assets | 68,686 | (13,187) | (1,550) |
| Accounts payable | (114,149) | 75,102 | 320,578 |
| Accrued expenses | (97,367) | 549,141 | 292,748 |
| Other liabilities | - | - | 64,695 |
| Contractual obligation | (100,000) | 250,000 | 150,000 |
| Net cash used in operating activities | (2,262,363) | (2,848,285) | (15,858,849) |
| | | | |
| **Cash flows from investing activities:** | | | |
| Dispositions (Additions) of property and equipment | 4,175 | (2,500) | (145,292) |
| Purchase of short term investments | - | - | (21,866,787) |
| Maturities of short term investments | - | - | 21,866,787 |
| Net cash provided by (used in) investing activities | 4,175 | (2,500) | (145,292) |
| | | | |
| **Cash flows from financing activities:** | | | |
| Proceeds from issuance of convertible debt | - | - | 400,000 |
| Proceeds from common stock option/warrant exercise | - | 2,700 | 67,900 |
| Net proceeds from issuance of common stock and warrants | - | 4,483,831 | 15,797,080 |
| Net proceeds from issuance of preferred stock | - | - | 238,732 |
| Payments on capital lease obligation, net | - | - | (21,815) |
| Net cash provided by financing activities | - | 4,486,531 | 16,481,897 |
| Net increase (decrease) in cash | (2,258,188) | 1,635,746 | 477,756 |
| | | | |
| Cash at beginning of period | $ 2,735,944 | $ 2,054,280 | $ - |

| | | | |
|---|---|---|---|
| Cash at end of period | $ 477,756 | $ 3,690,026 | $ 477,756 |
| | | | |
| **Supplemental disclosures of non-cash financing activity** | | | |
| Issuance of securities for obligation related to finder's fees | $ - | $ - | $ 47,500 |

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

**ARBIOS SYSTEMS, INC.**
(A Development Stage Company)
**CONDENSED STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT)**
**PERIOD FROM AUGUST 23, 2000 (INCEPTION) THROUGH SEPTEMBER 30, 2008**

| | Preferred Stock Shares | Preferred Stock Amount | Common Stock Shares | Common Stock Amount | Additional Paid-In Capital | Deferred Costs | Deficit Accumulated During the Development Stage | Total |
|---|---|---|---|---|---|---|---|---|
| Balance, August 23, 2000 (inception) restated for effect of reverse merger with Historical Autographs U.S.A. Inc. | - | $ - | - | $ - | $ - | $ - | $ - | $ - |
| Stock issuance in exchange for cash | | | 5,000,000 | 50 | 4,950 | | | 5,000 |
| Net loss | | | | | | | (9,454) | (9,454) |
| Balance, December 31, 2000, as restated | - | - | 5,000,000 | 50 | 4,950 | - | (9,454) | (4,454) |
| Issuance of junior preferred stock for cash of $250,000 and in exchange for $400,000 in patent rights, research and development costs, and employee loanout costs less issuance expenses of $11,268, June 29, 2001 | 681,818 | 7 | | | 958,278 | (343,553) | | 614,732 |
| Issuance of common stock in exchange for patent rights and deferred research and development costs | | | 362,669 | 4 | 547,284 | | | 547,288 |
| Services receivable | | | | | | (550,000) | | (550,000) |
| Deferred employee loan-out costs receivable earned | | | | | | 82,888 | | 82,888 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Net loss | | | | | | | (237,574) | (237,574) |
| Balance, December 31, 2001 | 681,818 | 7 | 5,362,669 | 54 | 1,510,512 | (810,665) | (247,028) | 452,880 |

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

**ARBIOS SYSTEMS, INC.**
(A Development Stage Company)
**CONDENSED STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT)**
**PERIOD FROM AUGUST 23, 2000 (INCEPTION) THROUGH SEPTEMBER 30, 2008**

| | Preferred Stock Shares | Preferred Stock Amount | Common Stock Shares | Common Stock Amount | Additional Paid-In Capital | Deferred Costs | Deficit Accumulated During the Development Stage | Total |
|---|---|---|---|---|---|---|---|---|
| Amendment of December 31, 2001 agreement for the issuance of common stock agreement in exchange for research and development services | | | | | (495,599) | 550,000 | | 54,401 |
| Deferred employee loan out costs receivable earned | | | | | | 171,776 | | 171,776 |
| Issuance of common stock for compensation | | | 70,000 | 1 | 10,499 | | | 10,500 |
| Issuance of common stock for cash | | | 999,111 | 9 | 149,857 | | | 149,866 |
| Net loss | | | | | | | (494,780) | (494,780) |
| Balance, December 31, 2002 | 681,818 | 7 | 6,431,780 | 64 | 1,175,269 | (88,889) | (741,808) | 344,643 |
| Issuance of common stock for cash less issuance expense of $2,956 | | | 417,000 | 417 | 246,827 | | | 247,244 |
| Issuance of common stock in private placement for cash less issuance expense of $519,230 | | | 4,000,000 | 4,000 | 3,476,770 | | | 3,480,770 |
| Issuance of common stock for convertible debenture less | | | 400,000 | 400 | 350,100 | | | 350,500 |

| | | | | |
|---|---|---|---|---|
| issuance expense of $49,500 | | | | |
| Shares issued in connection with acquisition of Historical Autographs U.S.A., Inc. on October 30, 2003 | 1,220,000 | 8,263 | (8,263) | - |

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

**ARBIOS SYSTEMS, INC.**
(A Development Stage Company)
**CONDENSED STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT)**
**PERIOD FROM AUGUST 23, 2000 (INCEPTION) THROUGH SEPTEMBER 30, 2008**

| | Preferred Stock Shares | Preferred Stock Amount | Common Stock Shares | Common Stock Amount | Additional Paid-In Capital | Deferred Costs | Deficit Accumulated During the Development Stage | Total |
|---|---|---|---|---|---|---|---|---|
| Value of warrants and beneficial conversion feature of bridge loan | | | | | 244,795 | | | 244,795 |
| Deferred employee loan-out costs receivable earned | | | | | | 88,889 | | 88,889 |
| Preferred Stock converted to Common Stock | (681,818) | (7) | 681,818 | 7 | | | | |
| Net loss | | | | | | | (885,693) | (885,693) |
| Balance, December 31, 2003 | - | - | 13,150,598 | 13,151 | 5,485,498 | - | (1,627,501) | 3,871,148 |
| Issuance of common stock options and warrants for compensation | | | | | 972,430 | | | 972,430 |
| Exercise of common stock options | | | 18,000 | 18 | 2,682 | | | 2,700 |
| Issuance of securities for payable | | | 47,499 | 47 | 47,451 | | | 47,498 |
| Net loss | | | | | | | (3,327,827) | (3,327,827) |
| Balance, December 31, 2004 | - | - | 13,216,097 | 13,216 | 6,508,061 | - | (4,955,328) | 1,565,949 |
| Issuance of common stock in private placement for cash less issuance expense of $384,312 | | | 2,991,812 | 2,992 | 6,224,601 | | | 6,227,593 |

| | | | | |
|---|---|---|---|---|
| Issuance of common stock options and warrants for compensation | | | 557,080 | 557,080 |
| Exercise of common stock options | 25,000 | 25 | 62,475 | 62,500 |

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

**ARBIOS SYSTEMS, INC.**
(A Development Stage Company)
**CONDENSED STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT)**
**PERIOD FROM AUGUST 23, 2000 (INCEPTION) THROUGH SEPTEMBER 30, 2008**

| | Preferred Stock Shares | Amount | Common Stock Shares | Amount | Additional Paid-In Capital | Deferred Costs | Accumulated During the Development Stage | Total |
|---|---|---|---|---|---|---|---|---|
| Net loss | | | | | | | (3,823,903) | (3,823,903) |
| Balance, December 31, 2005 | - | - | 16,232,909 | 16,233 | 13,352,217 | - | (8,779,231) | 4,589,219 |
| Issuance of common stock in private placement for cash less issuance expense of $95,013 | | | 1,227,272 | 1,227 | 1,253,760 | | | 1,254,987 |
| Issuance of common stock options and warrants for compensation | | | | | 703,839 | | | 703,839 |
| Stock warrant term extension | | | - | | 482,964 | | | 482,964 |
| Warrant liability | | | | | (1,284,841) | | | (1,284,841) |
| Net loss | | | | | | | (4,461,904) | (4,461,904) |
| Balance, December 31, 2006 | - | - | 17,460,181 | 17,460 | 14,507,939 | - | (13,241,135) | 1,284,264 |
| Cumulative effect of change in accounting principle: Adjust retained earnings at January 1, 2007 for change in accounting principle | | | | | | | (521,187) | (521,187) |
| Reclassification of warrants | | | | | 1,284,841 | | | 1,284,841 |
| Issuance of common stock and warrants in private placement for cash less issuance expense of $377,169 | | | 7,478,462 | 7,479 | 4,476,352 | | | 4,483,831 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Exercise of common stock warrants | | | 18,000 | 18 | 2,682 | | | 2,700 |
| Stock option based compensation expense | | | | | 438,263 | | | 438,263 |
| Stock warrant term extension | | | - | | 59,025 | | | 59,025 |
| Restricted stock based compensation expense | | | 621,818 | 621 | 315,604 | | | 316,225 |
| Issuance of warrants for patent acquistion | | | | | 74,570 | | | 74,570 |
| Net loss | | | | | | | (5,552,650) | (5,552,650) |
| Balance, December 31, 2007 | - | - | 25,578,461 | 25,578 | 21,159,276 | - | (19,314,972) | 1,869,882 |

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

**ARBIOS SYSTEMS, INC.**
(A Development Stage Company)
**CONDENSED STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT)**
**PERIOD FROM AUGUST 23, 2000 (INCEPTION) THROUGH SEPTEMBER 30, 2008**
(Unaudited)

| | Preferred Stock Shares | Preferred Stock Amount | Common Stock Shares | Common Stock Amount | Additional Paid-In Capital | Deferred Costs | Accumulated During the Development Stage | Total |
|---|---|---|---|---|---|---|---|---|
| Issuance of common stock for compensation | | | 214,286 | 214 | 59,786 | | | 60,000 |
| Stock option based compensation expense | | | | | 97,866 | | | 97,866 |
| Stock warrant term extension | | | - | | 175,256 | | | 175,256 |
| Restricted stock based compensation expense | | | - | - | 107,933 | | | 107,933 |
| Net loss | | | | | | | (2,547,201) | (2,547,201) |
| Balance, September 30, 2008 (unaudited) | - | - | 25,792,747 | $ 25,792 | $ 21,600,117 | - | $ (21,862,173) | $ (236,264) |

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

**Arbios Systems, Inc.**
**(A Development Stage Company)**
**Notes to Condensed Financial Statements (Unaudited)**
**Nine Months Ended September 30, 2008**

**(1) Basis of Presentation**

Arbios Systems, Inc., a Delaware corporation (the “Company”), seeks to develop, manufacture and market liver assist devices to meet the urgent need for therapy of liver failure.

On October 30, 2003, Historical Autographs U.S.A., Inc. and Arbios Technologies, Inc. (“ATI”) consummated a reverse merger, in which ATI became the wholly owned subsidiary of Historical Autographs U.S.A., Inc. Concurrently with the merger, Historical Autographs U.S.A., Inc. changed its name to Arbios Systems, Inc. and is herein referred to as “Arbios Systems”. The stockholders of ATI transferred ownership of one hundred percent of all the issued and outstanding shares of their capital stock of ATI in exchange for 11,930,598 newly issued shares, or approximately 91%, of the common stock, $.001 par value, of Arbios Systems. At that time, the former management of Arbios Systems resigned and was replaced by the same persons who served as officers and directors of ATI. Inasmuch as the former owners of ATI controlled the combined entity after the merger, the combination was accounted for as a purchase by ATI as acquirer, for accounting purposes in accordance with Statement of Financial Accounting Standards, (“SFAS”) No. 141: “Business Combinations” using reverse merger accounting, and no adjustments to the carrying values of the assets or liabilities of the acquired entity were required. Proforma operating results, as if the acquisition had taken place at the beginning of the period, have not been presented as the operations of the acquiree were negligible. The financial position and results of operations of Arbios Systems is included in the statements of the Company from the date of acquisition.

On July 25, 2005, Arbios Systems completed its reincorporation as a Delaware corporation by merging with and into Arbios Systems, Inc., a Delaware corporation (“Arbios”). The foregoing merger was approved by the Company’s stockholders at the annual meeting of stockholders held on July 7, 2005. In order to consolidate the functions and operations of Arbios and ATI, on July 26, 2005, ATI merged into Arbios. As a result, Arbios now owns all of the assets of ATI and all of the operations of the two companies have been consolidated into Arbios. Unless the context indicates otherwise, references herein to the “Company” during periods prior to July 26, 2005 include Arbios Systems, a Nevada corporation, and ATI.

The unaudited condensed financial statements and notes are presented as permitted by Form 10-Q. These unaudited condensed financial statements have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC"). Certain information and footnote disclosures, normally included in financial statements prepared in accordance with generally accepted accounting principles, have been omitted pursuant to such SEC rules and regulations. In the opinion of the management of the Company, the accompanying unaudited condensed financial statements include all adjustments, including those that are normal and recurring considered necessary to present fairly the financial position of the Company as of September 30, 2008, and the results of operations for the periods presented. These unaudited condensed financial statements should be read in conjunction with the Company's audited financial statements and the accompanying notes included in the Company's Annual Report on Form 10-KSB for the year ended December 31, 2007 as filed with the SEC. The Company expects that its operating results will fluctuate for the foreseeable future. Therefore, period-to-period comparisons should not be relied upon as predictive of the results in future periods. The results of operations for the nine months ended September 30, 2008 are not necessarily indicative of the results to be expected for any subsequent periods or for the entire 2008 fiscal year.

(2) **Going Concern**

The Company's financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America, which contemplate continuation of the Company on a going concern basis, and which contemplate the realization of assets and the satisfaction of liabilities in the normal course of business. The Company has incurred a net operating loss of $2,547,201 for the nine months ended September 30, 2008 and an accumulated deficit of $21,862,173 at September 30, 2008. In October 2008 we sold our HepatAssist bioartificial liver device to HepaLife Technologies, Inc. As part of the sale, we received $250,000 in cash, which provides us with additional working capital to continue to seek licensing, merger, or financing opportunities for our remaining SEPET technology into the first quarter of 2009. However, the Company's lack of adequate cash reserves to fund such activities to the end of the first quarter of 2009 and beyond raises substantial doubt about the Company's ability to continue as a going concern.

The Company reduced its staffing levels by 2 employees and 1 consultant in the first quarter of 2008 to reduce its administrative expenses. On August 5, 2008, the Company announced that it was suspending its operations to focus its efforts on obtaining financing or consummating a strategic transaction. In connection with the suspension of its operations, the Company on July 31, 2008 terminated the employment of Shawn Cain, Interim President and Chief Executive Officer, Scott Hayashi, Interim Chief Financial Officer, Jacek Rozga, MD, Ph.D., Chief Scientific Officer, and Susan Papalia, Vice President of Clinical Affairs (Mr. Cain and Mr. Hayashi continue to provide services to the Company as part-time consultants.) Upon the termination of their employment, each of the foregoing officers executed the Company's standard severance/termination agreement, and each of these officers received a severance payment in the following amount: Shawn Cain ($46,250, representing three month's salary), Scott Hayashi ($20,833, representing two month's salary), Jacek Rozga ($33,333, representing two month's salary), and Susan Papalia ($28,333, representing two month's salary).

If the Company is unsuccessful in its efforts to raise additional funds through the sale of additional equity securities or a strategic transaction, the Company will not have the ability to continue as a going concern into the first quarter of 2009. If the Company is unable to obtain financing, it will wind down operations and actively seek the sale of the assets, licensing of its SEPET™ technology, or exploring a potential merger with another company. While the Company hopes to pursue development of its product candidate, any significant continued development is contingent upon significant additional funding or a strategic partnership. The amount and timing of future capital requirements will depend on numerous factors, including the number and characteristics of product candidates that the Company pursues, the conduct of clinical studies, the status and timelines of regulatory submissions, the costs associated with protecting patents and other proprietary rights, the ability to complete strategic collaborations and the availability of third-party funding, if any. The Company may also seek additional funding through corporate collaborations and other financing vehicles. If funds are obtained through arrangements with collaborative partners or others, the Company may be required to relinquish rights to its technologies or product candidates.

No assurance can be given that the Company will be successful in raising additional capital or will complete a strategic transaction. Furthermore, there can be no assurance, assuming the Company successfully raises additional equity or closes a strategic transaction, that the Company will achieve profitability or positive cash flow. If the Company is unable to raise additional capital or close a strategic transaction for the Company by the first quarter of 2009, the Company will not be able to meet its obligations and will have to cease all operations. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

**(3) Recent Accounting Pronouncements**

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements," or SFAS 157. SFAS 157 establishes a single authoritative definition of fair value, sets out a framework for measuring fair value, and requires additional disclosures about fair-value measurements. SFAS 157 applies only to fair value measurements that are already

required or permitted by other accounting standards (except for measurements of share-based payments) and is expected to increase the consistency of those measurements. Accordingly, SFAS 157 does not require any new fair value measurements. However, for some entities, the application of SFAS 157 will change current practice. SFAS 157 is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The adoption of FAS 157 did not have a material impact on the financial position or results of operations.

In February 2007, the FASB issued FASB Statement No.159: "The Fair Value Option for Financial Assets and Financial Liabilities – including an amendment of FASB Statement No. 115" ("FAS 159"). This statement permits entities to choose to measure many financial instruments and certain other items at fair value and is expected to expand the use of fair value measurement. FASB 159 is effective for fiscal years beginning after November 15, 2007. The Company has adopted FAS 159 and the adoption did not have a material impact on the financial position or results of operations.

On June 27, 2007, the FASB reached a final consensus on EITF Issue No. 07-03: "Accounting for Advance Payments for Goods or Services to Be Used in Future Research and Development Activities" ("EITF 07-03"). Currently, under FASB Statement No. 2: "Accounting for Research and Development Costs," nonrefundable advance payments for future research and development activities for materials, equipment, facilities and purchased intangible assets that have no alternative future use are expensed as incurred. EITF 07-03 addresses whether such non-refundable advance payments for goods or services that have no alternative future use and that will be used or rendered for research and development activities should be expensed when the advance payments are made or when the research and development activities have been performed. The consensus reached by the FASB requires companies involved in research and development activities to capitalize such non-refundable advance payments for goods and services pursuant to an executory contractual arrangement because the right to receive those services in the future represents a probable future economic benefit. Those advance payments will be capitalized until the goods have been delivered or the related services have been performed. Entities will be required to evaluate whether they expect the goods or services to be rendered. If an entity does not expect the goods to be delivered or services to be rendered, the capitalized advance payment will be charged to expense. The consensus on EITF 07-03 is effective for financial statements issued for fiscal years beginning after December 15, 2007, and interim periods within those fiscal years. Earlier application is not permitted. Entities are required to recognize the effects of applying the guidance in EITF 07-03 prospectively for new contracts entered into after the effective date. In accordance with EITF 07-03, the Company does evaluate its research and development contracts and payments within the guidance of EITF 07-03 and either expenses or capitalizes such payments based upon the contract terms.

In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities" The new standard is intended to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable users of the financial statements to better understand the effects on an entity's financial position, financial performance, and cash flows. It is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. The Company is evaluating the impact of adopting SFAS 161 on our financial statements.

**(4) Stock-Based Compensation:**

On January 1, 2008, in accordance with the established Board of Director's compensation program, the Company granted 90,000 options to purchase common stock to Board members with an exercise price of $0.69 per share, the closing market price of the Company's common stock on the date of grant, valued at approximately $47,229, which vest on a monthly pro-rata basis over one year. The fair value of the options was determined using the Black Scholes option pricing model utilizing the following assumptions: risk free interest rate 2.98%, stock price volatility 0.84, expected life 7 years, dividend yield 0%.

On January 28, 2008, the Company granted 70,000 options to purchase common stock to employees with an exercise price of $0.60 per share, the closing market price of the Company's common stock on the date of grant, valued at approximately $32,000, which vest upon the achievement of a performance milestone by December 31, 2008. The fair value of the options was determined using the Black Scholes option pricing model utilizing the following assumptions: risk free interest rate 2.98%, stock price volatility 0.84, expected life 7 years, dividend yield 0%. As of June 30, 2008, and through the current reporting period, the Company has determined that it is not probable that the performance objective will be met, and in accordance with SFAS 123R, the incremental vesting charges incurred

through March 31, 2008 of approximately $5,800 was reversed during the second quarter of 2008.

On January 28, 2008, the Company issued 25,000 shares of restricted stock with restrictions that are removed upon achievement of a performance milestone by December 31, 2008, to an advisor and current member of the Board of Directors as compensation for services at a price of $0.01 per share. The approximate $15,000 value of these restricted shares, based on the closing price of the Company's common stock on the date of issuance, was expensed with a corresponding increase in additional paid in capital. The Company estimated that as of June 30, 2008, and through the current reporting period, it is not probable that the performance objective will be met, and in accordance with SFAS 123R, the incremental vesting charges incurred through March 31, 2008 of $15,000 was reversed during the second quarter of 2008.

On March 25, 2008, the Company issued 250,000 options to purchase common stock with an exercise price of $0.30 per share, the closing market price of the Company's common stock on the date of grant, to employees as a retention incentive and to compensate employees for a salary deferral that began on April 1, 2008, which options were valued at approximately $57,000 and vested as long as the employee remained with the Company until a financing was achieved. These options are considered performance based options. The Company estimated that as of June 30, 2008 it was not probable that the performance objective would be met, and in accordance with SFAS 123R, the incremental vesting charges incurred through March 31, 2008 of approximately $4,000 were reversed during the second quarter of 2008. The fair value of the options was determined using the Black Scholes option pricing model utilizing the following assumptions: risk free interest rate 2.48%, stock price volatility 0.84, expected life 7 years, dividend yield 0%.

On April 29, 2008, the Company entered into an agreement with a fund raising firm and issued 214,286 shares of common stock at a price of $0.28 per share as compensation plus other agreed upon terms. The value of the shares, based on the closing price of the Company's common stock on the date of grant, was recorded as a deferred financing expense of $60,000 with a corresponding increase in additional paid in capital. An additional $30,000 cash retainer was also recorded as a deferred financing cost for legal and other expenses. These costs were subsequently expensed as of June 30, 2008 due to the termination of the agreement.

On July 18, 2008, the Company issued 50,000 options to purchase common stock with an exercise price of $0.05 per share, the closing market price of the Company's common stock on the date of grant, to a consultant per the provisions of a previously negotiated scientific consulting agreement as compensation. The value of the option grant is $2,087. The stock option vested 100% immediately on the date of grant and the termination clause was extended from 90 days to 180 days to compensate for ongoing consulting services from the consultant.

During the three months ended September 30, 2008 and 2007, the Company recognized equity based compensation expense for stock options of $22,000 and $156,000, respectively, which was recognized in the Statement of Operations. During the nine months ended September 30, 2008 and 2007, the Company recognized equity based compensation expense for stock options of $98,000 and $346,000, respectively, which was recognized in the Statement of Operations. As of September 30, 2008, the total compensation costs related to non-vested awards not yet recognized is $11,000 which will be recognized over the next three months. As of September 30, 2008, there were 2,906,677 options to purchase common stock outstanding under the Company's 2005 Stock Option Plan.

**(5) Warrant Extension**

On February 15, 2008, the Company amended outstanding warrants to purchase an aggregate of 900,000 shares of common stock of the Company, which have an exercise price of $1.00 per share (the "Warrants"). The Warrants were originally issued in 2003 in connection with certain financing transactions and were scheduled to expire on February 15, 2008. The amendment extends the expiration date of the Warrants until February 15, 2010. The value of the extension of the warrants was calculated using the Black Scholes pricing model and resulted in a charge of approximately $176,000, which was recorded in the statement of operations during the first quarter of 2008.

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In addition, the Warrants contain a call provision whereby the Company can require the holders of the Warrants to exercise them if the Company's common stock trades at a level of at least $3.25 per share for 20 consecutive trading days (the "Call Provision"). In addition to amending the expiration date of the Warrants as described in the preceding paragraph, the Company amended the Call Provision by lowering the trading price at which the Call Provision may be triggered from $3.25 per share to $2.25 per share.

**(6) Subsequent Event**

October 3, 2008, the Company executed an Asset Purchase Agreement with HepaLife Technologies, Inc (HepaLife) and concurrently therewith consummated the transactions contemplated thereby. Pursuant to the Asset Purchase Agreement, the Company sold to HepaLife its HepatAssist™ cell-based liver support system that the Company acquired in 2004 from Circe Biomedical, Inc. The Company had previously suspended its development of the HepatAssist technology pending receipt of additional funding for this program from a corporate marketing partner or a significant capital raise. The HepatAssist assets sold to HepaLife include 12 patents and patent licenses, miscellaneous equipment, an FDA IND application including orphan drug and fast track designation, Phase I and Phase II/III clinical protocols and clinical data, as well as standard operating procedures for manufacturing and quality control. The value of the patents sold was greater than its carrying value; therefore, no loss was recognized at September 30, 2008.

The purchase price received by the Company for the HepatAssist assets that it sold consisted of (i) $450,000, of which $250,000 was paid in cash at the closing and $200,000 has been deferred for up to 18 months, (ii) a Series D warrant to purchase up to 750,000 shares of HepaLife's common stock at an exercise price of $0.35 per share for a period of five years (the "Warrant"), and (iii) the assumption by HepaLife of the Company's obligations under certain agreements related to the HepatAssist licenses and related agreements. The deferred $200,000 payment is due and payable on the earlier of (i) the date on which HepaLife has consummated one or more debt or equity financings in which the gross proceeds received in the aggregate equal or exceed $4,000,000, or (ii) the eighteen month anniversary of the closing date. HepaLife has granted the Company piggy-back and certain other registration rights to register for public resale the shares issuable upon the exercise of the Warrant. HepaLife is a publicly traded company whose common stock is traded on the OTC Bulletin Board under the symbol "HPLF." The foregoing sale did not include the Company's principal asset, its extracorporeal blood purification therapy known as the "SEPET™ Liver Assist Device."
Per Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," a long-lived asset which is to be sold shall be classified as held for sale in the period in which the asset is being actively marketed and solicitation of buyers and sale of the asset is probable. As of the period ending September 30, 2008, the Company had a signed letter of intent to sell the HepatAssist asset and subsequently, $116,931 in patent rights have been reclassified from "Patent Rights" to "Assets Held for Sale" representing the carrying value of the patents included in this transaction. For year-over-year comparative purposes, patent rights of $132,293 at December 31, 2007 have been reclassified to "Assets Held for Sale."

On October 6, 2008, the Company entered into a new Compensation Agreement with Shawn Cain, the Company's Interim Chief Executive Officer and President. The Compensation Agreement is retroactively effective as of October 1, 2008. Under the Compensation Agreement, Mr. Cain has agreed to assist the Company at least until December 31, 2008 in selling, licensing or otherwise financing the Company's assets. In consideration for his services, the Company has agreed to pay Mr. Cain (i) $10,000 per month plus payment of medical insurance, estimated to be $1,500 per month, and (ii) an incentive a cash bonus following the sale, license or financing of the Company's SEPET assets, which incentive payment will be determined in the sole discretion of the Board after taking into account the timing, size and structure of the transaction. In addition, under the Compensation Agreement, the Company has agreed to pay Mr. Cain a cash bonus of $20,000 as compensation for his services in connection with the sale of the HepatAssist assets to HepaLife described above.

On November 10, 2008, the Company entered into a new Compensation Agreement with Scott Hayashi, the Company's Interim Chief Financial Officer. The Compensation Agreement is retroactively effective as of October 1, 2008. Under the Compensation Agreement, Mr. Hayashi has agreed to continue to provide services to the Company as a part-time consultant for a period of three months at a rate of $6,500 per month. Mr. Hayashi is also eligible for an incentive payment following the sale, license, or financing of the Company's SEPET assets, the exact amount to be determined in the sole discretion of the Board after taking into account the timing, size and structure of the transaction. Under the terms of the consulting agreement, Mr. Hayashi will act as the interim principal financial officer of the Company at least until December 31, 2008.

**ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

**SAFE HARBOR STATEMENT**

*In addition to historical information, the information included in this Quarterly Report on Form 10-Q contains forward-looking statements, such as those pertaining to our capital resources, our ability to complete the research and development of our product candidates, and our ability to obtain regulatory approval for our product candidates. Forward-looking statements involve numerous risks and uncertainties and should not be relied upon as predictions of future events. Certain such forward-looking statements can be identified by the use of forward-looking terminology such as "believes," "expects," "may," "will," "should," "seeks," "approximately," "intends," "plans," "pro forma," "estimates," or "anticipates" or other variations thereof or comparable terminology, or by discussions of strategy, plans or intentions. Such forward-looking statements are necessarily dependent on assumptions, data or methods that may be incorrect or imprecise and may be incapable of being realized. The following factors, among others, including those risks set forth under "Factors That May Affect our Business And Our Future Results and Market Price of Our Stock," included in Item 6 "Management's Discussion and Analysis of Plan of Operation" of our Annual Report on Form 10-KSB for the year ended December 31, 2007 and other filings we make with the Securities and Exchange Commission could cause actual results and future events to differ materially from those set forth or contemplated in the forward-looking statements: need for a significant amount of additional capital, lack of revenue, uncertainty of product development, ability to obtain regulatory approvals in the United States and other countries, and competition. Readers are cautioned not to place undue reliance on forward-looking statements, which reflect our management's analysis only. We assume no obligation to update forward-looking statements.*

**Overview**

To date, we have been principally engaged in research and development of our product candidates, management of clinical trials, raising capital and recruitment of additional scientific and management personnel and advisors. We have not marketed or sold any products and have not generated any revenues from commercial activities; however, from inception, we have recorded revenues of approximately $321,000 of Small Business Innovation Research, or SBIR, grants that have been awarded by the United States Small Business Administration.

In August 2008, we suspended our operations and are currently focusing exclusively on obtaining financing or consummating a strategic transaction. We hope to obtain additional financing through the sale of additional equity and possibly through a strategic alliance(s) with a larger pharmaceutical or biomedical company. In order to preserve our remaining cash resources, the Company's terminated its remaining employees on July 31, 2008. However, in order to obtain the limited administrative and other services required to maintain and preserve the Company's assets and to coordinate the Company's efforts to obtain funding and pursue strategic alternatives, the Company engaged Shawn Cain, the Company's former President and Chief Executive Officer, to serve as its Interim President and CEO through December 31, 2008, and engaged Scott Hayashi, the Company's former Chief Financial Officer, to service as its Interim CFO through December 31, 2008. Messrs. Cain and Hayashi will provide these services to as part-time consultants. In addition, in order to obtain additional working capital and to monetize some of its unutilized assets, the Company on October 3, 2008 sold its HepatAssist assets for (i) $450,000, of which $250,000 was paid in cash at the

closing and $200,000 has been deferred for up to 18 months, (ii) a Series D warrant to purchase up to 750,000 shares of common stock of HepaLife Technologies, Inc. Based on the current reduced budget and estimated expenses, we believe that our current cash resources (including the amounts we received from HepaLife Technologies, Inc. on October 3, 2009) will be sufficient to fund our reduced level of operations into the first quarter of 2009. If we do not obtain financing or enter into a strategic transaction by the first quarter of 2009, we will then need to consider other options, including liquidation of the Company and its assets.

Previously, our plan of operations was to continue our research and development activities, including clinical trials for the SEPET™ Liver Assist Device and the preparation and submission of an application for a CE Mark for European marketing approval. Our plan was, however, dependent upon obtaining additional financing or engaging in a strategic transaction. In accordance with our plan of operations, we submitted an IDE application for SEPET™ in March 2005 and commenced clinical trials for SEPET™ in the third quarter of 2005. In the third quarter of 2007, we completed the Phase I feasibility clinical trial for SEPET™. Based upon the results of the feasibility study, we submitted an IDE application to the FDA seeking approval to initiate a pivotal trial of SEPET™. Following a meeting with the FDA in the summer of 2007, the FDA granted us conditional approval of the IDE application in February 2008 to begin the pivotal clinical trial while we respond to the FDA's conditions and request for additional information. After additional discussions with the FDA, we submitted a revised IDE application to the FDA and in May 2008 the FDA granted us approval of the revised IDE to begin the pivotal trial of SEPET™. Subject to receiving financing, we expected that there would be three segments to the pivotal trial of SEPET™ at up to 24 clinical sites in the United States and Europe and that we would be able to begin enrolling patients for the first segment of the trial in clinical sites in Germany in 2009. Depending on the amount of financing we received, we also considered devoting the remaining company resources toward a European approval strategy through our CE Marking efforts which commenced in April 2008. We are also are considering licensing our SEPET technology if we are unable to raise sufficient capital to fund the clinical trial and continue operations.

To date we have not been able to raise sufficient funds to effect our prior business plan. Accordingly, in August 2008, we suspended our current operations, including all clinical trials, until, if ever, we raise sufficient cash to resume our operations. In order to provide the Company with cash while we investigate potential financing/strategic alternatives, in October 2008 we sold our HepatAssist bioartificial liver device to a public company. As part of the sale, we received $250,000 in cash, which will provide us with additional working capital while we continue to seek licensing, merger, or financing opportunities for our remaining SEPET technology. There is no guarantee that we will be able to raise sufficient capital by the first quarter of 2009 to support operations and development of the SEPET technology or that we will be able to license or dispose of our SEPET technology in that period. Based on our current estimates, we believe that we do not have sufficient financial resources to conduct our planned operations and that our current cash and cash equivalents are only expected to last into the first quarter of 2009. The amount of funds that we need to raise in the short term to fund our operations is relatively small because of our reduced level of operations. However, under our agreement with Immunocept LLC, we are obligated to raise substantially more funds this calendar year in order to maintain our Immunocept LLC licenses. Under those licenses, we will need to raise an aggregate of at least $5.0 million during 2008 in order to ensure maintenance of the license to the Immunocept patent portfolio. Accordingly, failure to raise additional capital in the near future could result in the termination of all our operations, the loss of significant patents, and our liquidation.

**Critical Accounting Policies**

This discussion is based on our unaudited condensed financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these unaudited condensed financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, management evaluates its estimates, including those related to revenue recognition, impairment of long-lived assets and their useful lives, including finite lived intangible costs, accrued liabilities and certain expenses. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ materially from these estimates under different assumptions or conditions.

Our significant accounting policies are summarized in Note 1 to our audited financial statements for the year ended December 31, 2007 included in our Annual Report on Form 10-KSB as filed with the Securities and Exchange

Commission. We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our unaudited condensed financial statements:

*Development Stage Enterprise*

We are a development stage enterprise as defined by the Financial Accounting Standards Board's, or FASB, Statement of Financial Accounting Standards, or SFAS, No. 7, "Accounting and Reporting by Development Stage Enterprises." All losses accumulated since our inception have been considered part of our development stage activities.

*Short Term Investments*

Short-term investments generally mature between three and twelve months. Short term investments consist of U.S. government agency notes purchased at a discount with interest accruing to the notes full value at maturity. All of our short-term investments are classified as available-for-sale and are carried at fair market value which approximates cost plus accrued interest.

*Patents*

In accordance with SFAS No. 2, “Accounting for Research and Development Costs,” the costs of intangibles we purchased from others for use in research and development activities and that have alternative future uses are capitalized and amortized. We capitalize certain patent rights that are believed to have future economic benefit. The licensed capitalized patents costs were recorded based on the estimated value of the equity security issued by us to the licensor. The value ascribed to the equity security took into account, among other factors, our stage of development and the value of other companies developing extracorporeal bioartificial liver assist devices. These patent rights are amortized using the straight-line method over the remaining life of the patent. Certain patent rights received in conjunction with purchased research and development costs have been expensed. Legal costs incurred in obtaining, recording and defending patents are expensed as incurred.

*Stock-Based Compensation*

Commencing January 1, 2006, we adopted SFAS No. 123R, “Share Based Payment”, or SFAS 123R, which requires all share based payments, including grants of stock options, to be recognized in the income statement as an operating expense, based on fair values.

Prior to adopting SFAS 123R, we accounted for stock-based employee compensation under Accounting Principles Board Opinion No. 25, “Accounting for Stock Issued to Employees,” as allowed by SFAS No. 123, the predecessor to SFAS 123R, “Accounting for Stock-Based Compensation,” the predecessor to SFAS 123R. Accordingly, we have applied the modified prospective method in adopting SFAS 123R whereby periods prior to adoption have not been restated.

*Accounting for Uncertainty in Income Taxes*

In July 2006, the FASB issued Interpretation No. 48, “Accounting for Uncertainty in Income Taxes,” or FIN 48. This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an entity’s financial statements and prescribes a recognition threshold of more-likely-than-not to be sustained upon examination. Measurement of the tax uncertainty occurs if the recognition threshold has been met. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. In the normal course of business we are subject to examination by taxing authorities. At present, there are no ongoing audits or unresolved disputes with the various tax authorities that we file with. Given our substantial net operating loss carryforwards as well as historical operating losses, the adoption of FIN 48 on January 1, 2007 did not have any effect on our financial position, results of operations or cash flows as of or for the period ended September 30, 2008.

**Results of Operations**

Since we have been involved in developing our product candidates and do not have any products available for sale, we have not yet generated any revenue from sales. Inception to date revenue represents revenue recognized from a SBIR government grant.

General and administrative expenses of $147,000 and $1,025,000 were incurred for the three months ended September 30, 2008 and 2007, respectively. General and administrative expenses for the three months ended September 30, 2008 decreased by $878,000 from the prior year's level, reflecting our suspended operations during the September 30, 2008 fiscal quarter. The decrease is primarily attributed to a $312,000 severance and accrued vacation payment incurred in 2007 to our former CEO, a $128,000 decrease in non cash option charges due to a decline in the number of stock options granted and to a decline in the Company's stock price, a $82,000 decline in payroll costs due to staff reductions, salary deferrals and non-payment of 2008 bonuses, and to a $72,000 decrease in legal fees. In addition, there also was an overall decline in virtually all expense categories as a result of our efforts to reduce general and administrative costs. General and administrative expenses of $1,359,000 and $2,651,000 were incurred for the nine months ended September 30, 2008 and 2007, respectively. General and administrative expenses for the nine months ended September 30, 2008 decreased by $1,292,000 over the prior year's level due to cost reductions and the suspension of most administrative activities on July 31, 2008. A portion of the decrease in general and administrative expenses is the result of higher expenses incurred in the 2007 fiscal period as a result of a $312,000 severance payment incurred in 2007 to the former CEO and a $180,000 non recurring contingency charge incurred in 2007. However, the decrease in general and administrative expenses in 2007 also is due to a $303,000 decrease in non cash option charges due to a decline in the number of stock options granted and a decline in the Company's stock price, a $247,000 decline in payroll costs due to staff reductions, salary deferrals and non-payment of 2008 bonuses and a $128,000 decrease in legal fees, and an overall decline in virtually all expense categories in an effort to reduce general and administrative costs.

Research and development expenses of $164,000 and $423,000 were incurred for the three months ended September 30, 2008 and 2007, respectively. The research and development expenses for the three months ended September 30, 2008 decreased by $259,000 over the comparable prior year level due to $172,000 less in consulting costs primarily from regulatory consultants utilized in 2007 and a decline of $45,000 in SEPET™ clinical development costs. Research and development expenses of $1,221,000 and $1,983,000 were incurred for the nine months ended September 30, 2008 and 2007, respectively. The research and development expenses for the nine months ended September 30, 2008 decreased by $762,000 over the comparable prior year levels due to $375,000 in costs related to the Immunocept, LLC patent portfolio acquisition in March 2007 and a decline in SEPET™ development costs of $195,000 in 2008, the development of which has been placed on hold until additional capital is secured and a decline in consultant costs of $231,000 also related to the SEPET™ program's suspension. These declines are offset in part by an increase of $79,000 due to the addition of one employee over 2007 employment levels.

Interest income of $4,000 and $53,000 was earned for the three months ended September 30, 2008 and 2007, respectively. Interest income of $32,000 and $128,000 was earned for the nine months ended September 30, 2008 and 2007, respectively. The change in interest income primarily reflects lower cash and cash equivalent balances in 2008 from prior year levels and fluctuations of the interest rate in our cash account.

Our net loss was $308,000 and $1,394,000 for the three months ended September 30, 2008 and 2007, respectively. Our net loss was $2,547,000 and $4,506,000 for the nine months ended September 30, 2008 and 2007, respectively. The decrease in net loss for the three and nine months ended June 30, 2008 compared to the comparable periods in 2007 is primarily attributable to the reductions in research and development program activities and a decrease in general and administrative expenditures as we endeavored to conserve cash and secure additional capital.

**Liquidity and Capital Resources**

As of September 30, 2008, we had cash of approximately $478,000, current liabilities of approximately $707,000, and long term contract obligations of $150,000 related to patent acquisitions. Reductions in the accounts payable balance resulted from negotiated vendor concessions. In October 2008, we received a cash payment of $250,000 from the sale of our HepatAssist asset, which additional funding will allow the Company to operate into the first quarter of 2009. To date, we have funded our operations primarily from the sale of debt and equity securities and to a lesser extent, SBIR

grants.

As of the date of the filing of the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2008, we estimate that we have cash to operate into the first quarter of 2009. We are continuing to pursue fund-raising possibilities through the sale of our equity securities or strategic transactions. If we are unsuccessful in our efforts to raise additional funds through the sale of additional equity securities, we will not have the ability to continue as a going concern after the first quarter of 2009. While we hope to pursue development of our product candidates, any continued development by us is contingent upon significant additional funding or a strategic partnership. The amount and timing of our future capital requirements will depend on numerous factors, including the financial markets in general, and the perceived value of our company and our assets in particular. While we are pursuing raising equity funding, we may also seek funding through corporate collaborations and other financing vehicles. We do not have any agreements in place to either obtain additional financing or for any strategic arrangements, and no assurance can be given that we will be able to obtain such funding, or that we will be able to find a strategic partner before all of our capital is expended.

We do not currently anticipate that we will derive any revenue from either product sales or from governmental research grants in the foreseeable future. The cost of completing the development of our product candidates and of obtaining all required regulatory approvals to market our product candidates is substantially greater than the amount of funds we currently have available and substantially greater than the amount we could possibly receive under any governmental grant program. As a result, we will have to obtain significant additional funds after the date of this report. We cannot be sure that we will be able to obtain additional funding from either of these sources or that we will enter into strategic alliances, or that the terms under which we obtain such funding or of any such strategic alliance will be beneficial to us or our shareholders.

The following is a summary of our contractual cash obligations for the following fiscal years:

| **Contractual Obligations** | **Total** | **2008** | **2009** | **2010** | **2011** |
|---|---|---|---|---|---|
| License Agreement | $ 250,000 | –$ | 100,000 $ | 150,000 | – |
| Total | $ 250,000 $ | –$ | 100,000 $ | 150,000 $ | – |

We do not believe that inflation has had a material impact on our business or operations.

We do not engage in trading activities involving non-exchange traded contracts. In addition, we have no financial guarantees, debt or lease agreements or other arrangements that could trigger a requirement for an early payment or that could change the value of our assets.

**Off- Balance Sheet Arrangements**

We are not a party to any off-balance sheet arrangements.

**ITEM 3. Qualitative and Quantitative Disclosures about Market Risk.**

Not applicable as we are a smaller reporting company.

**ITEM 4T. Controls and Procedures.**

*(a) Evaluation of Disclosure Controls and Procedures*. As of the end of the period covered by this report, our company conducted an evaluation, under the supervision and with the participation of our Interim Chief Executive Officer and Chief Financial Officer, of our disclosure controls and procedures (as defined in Rules 13a-15(e) of the Securities Exchange Act of 1934, as amended, or the Exchange Act). Based on this evaluation, our Interim Chief

Executive Officer and Chief Financial Officer concluded that our company's disclosure controls and procedures are effective to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosures.

*(b) Changes in Internal Controls*. There was no change in our internal controls, which are included within disclosure controls and procedures, during our most recently completed fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal controls.

*(c) Limitations on the Effectiveness of Controls*. Our management, including our interim chief executive officer and chief financial officer, does not expect that our disclosure controls and procedures or our internal control over financial reporting will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within an organization have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake.

Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving our stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

**PART II. OTHER INFORMATION**

**ITEM 1. Legal Proceedings.**

None.

**ITEM 1A. Risk Factors.**

Information regarding risk factors appears under “Factors That May Affect our Business And Our Future Results and Market Price of Our Stock,” included in Item 6 “Management’s Discussion and Analysis of Plan of Operation” of our Annual Report on Form 10-KSB for the year ended December 31, 2007 as filed with the Securities and Exchange Commission. Except as set forth below, there have been no material changes from the risk factors previously disclosed in that Annual Report on Form 10-KSB.

***We are in imminent danger of liquidation and the loss of our entire business if we do not raise additional funds or enter into a strategic transaction in the immediate future.***

As of the date of the filing of this report, we only have sufficient cash available to fund our scaled back operations into the first quarter of 2009. In order to preserve our limited cash resources, we have suspended our operations and have terminated all employees (only our Interim Chief Executive Officer and our Interim Chief Financial Officer continue to provide services to us as part-time consultants). We are currently seeking additional funding from various sources and are considering certain strategic transactions to either fund and re-instate our operations or to otherwise preserve the value of our patents and technologies. However, we do not have any agreements in place for either additional funding or for any strategic transactions, and no assurance can be given that we will be able to obtain additional financing or enter into a strategic transaction. If we do not raise additional funds in the immediate future or otherwise protect our business and assets in a strategic transaction, we will have to consider filing for bankruptcy or otherwise liquidating our company. In either case, our shareholders will lose their investment in our securities.

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***Management is engaged on a part-time basis until at least December 31, 2008, but there is no assurance that the Company can continue to receive such consulting services until or beyond such date***

Our Interim Chief Executive Officer, Shawn Cain, and Interim Chief Financial Officer, Scott Hayashi, are parties to consulting agreements to provide us with part time management services until at least December 31, 2008. However, there is a risk that one or both executives could choose to leave us before that date to pursue other interests, and there can be no assurance that such consulting agreements can be extended beyond that date, should we continue to seek potential licensing or sale agreements or other options such as liquidation or bankruptcy.

***We must raise at least $5.0 million by December 31, 2008 under the terms of our license respecting Immunocept, LLC's patent portfolio in order to maintain our rights to that technology***

Under our license agreement with Immunocept LLC, we are obligated to raise an aggregate of at least $5.0 million by December 31, 2008 in order to maintain our license to the Immunocept LLC technology. Loss of our rights to such technology could substantially impair our ability to realize value from our programs. Additionally, we must remit a cash milestone payment of $100,000 to Immunocept, LLC on January 1, 2009 under the terms of the license agreement which would significantly decrease our cash position.

**ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

None.

**ITEM 3. Defaults Upon Senior Securities.**

None.

**ITEM 4. Submission of Matters to a Vote of Security Holders.**

None.

**ITEM 5. Other Information.**
None.

**ITEM 6. Exhibits.**

| | |
|---|---|
| 31.1 | Certification of Principal Executive Officer Pursuant to Section 302 |
| 31.2 | Certification of Principal Financial Officer Pursuant to Section 302 |
| 32 | Section 906 certification of periodic financial report by Chief Executive Officer and Chief Financial Officer. |
| 33 | Compensation Agreement Between Scott Hayashi and Company dated November 10, 2008 |

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

ARBIOS SYSTEMS, INC.

DATE: November 14, 2008

By: /S/ Shawn P. Cain
Shawn P. Cain
Interim Chief Executive Officer (Principal Executive Officer)

DATE: November 14, 2008

By: /S/ Scott L. Hayashi
Scott L. Hayashi
Interim Chief Financial Officer (Principal Financial Officer)