NEPHROS INC
Form 10QSB
November 15, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-QSB

(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, 2006
OR

[ ] TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _________ to ________

Commission file number 001-32288

NEPHROS, INC.
(Exact Name of Small Business Issuer as Specified in Its Charter)

Delaware	13-397 1809
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

3960 Broadway
New York, NY 10032
(Address of Principal Executive Offices)

(212) 781-5113
(Registrant's telephone number, including area code)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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 shell company (as defined in Rule 12b-2 of the Exchange Act: YES | | NO |X|

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date:

Class	Outstanding at November 14, 2006
Common Stock, $.001 par value	12,317,992

Transitional Small Business
Disclosure Format: YES [ ] NO [X]

NEPHROS, INC. AND SUBSIDIARY

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

NEPHROS, INC. AND SUBSIDIARY
CONDENSED CONSOLIDATED BALANCE SHEETS
(unaudited)

	September 30, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 923,957	$ 746,581
Short-term investments	3,800,000	4,500,000
Accounts receivable, less allowances: 2006: $37,157; 2005: $18,697	472,944	244,100
Inventory	463,442	814,548
Prepaid expenses and other current assets	380,905	358,306
Total current assets	6,041,248	6,663,535
Property and equipment, net	943,061	1,143,309
Other assets	17,732	17,731
Total assets	$ 7,002,041	$ 7,824,575
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 762,260	$ 766,158
Accrued expenses	273,020	451,109
Accrued severance expense	-	318,250
Note payable - short-term portion	379,751	295,838
Total current liabilities	1,415,032	1,831,355
Convertible notes payable	5,210,860	-
Accrued interest - convertible notes	103,430	-
Note payable - long-term portion	184,025	613,727
Total liabilities	6,913,347	2,445,082
Stockholders' equity:		
Common stock	12,318	12,313
Additional paid-in capital	53,114,329	54,848,711
Deferred compensation	-	(2,189,511)
Accumulated other comprehensive loss	(36,694)	(49,137)
Accumulated deficit	(53,001,259)	(47,242,883)
Total stockholders' equity	88,694	5,379,493
Total liabilities and stockholders' equity	$ 7,002,041	$ 7,824,575

See accompanying notes to the condensed consolidated financial statements

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NEPHROS, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited)

	Three Months Ended September 30		Nine Months Ended September 30	
	2006	**2005**	**2006**	**2005**
Contract revenues	$ -	$ -	$ -	$ 1,750,000
Net product revenues	164,699	225,248	641,115	603,339
Net revenues	164,699	225,248	641,115	2,353,339
Cost of goods sold	202,839	151,646	810,677	400,695
Gross (loss) profit	(38,140)	73,602	(169,562)	1,952,644
Operating expenses:				
Research and development	544,505	401,873	1,444,281	1,415,584
Depreciation expense	64,223	75,345	224,250	230,050
Selling, general and administrative	1,256,354	1,404,660	3,965,817	4,658,975
Total operating expenses	1,865,082	1,881,878	5,634,348	6,304,609
Loss from operations	(1,903,222)	(1,808,276)	(5,803,910)	(4,351,965)
Interest income	116,014	60,394	163,855	178,863
Interest expense	113,494	-	113,494	-
Other expense	4,826	-	4,826	-
Net loss	$ (1,905,528)	$ (1,747,882)	$ (5,758,375)	$ (4,173,102)
Basic and diluted net loss per common shares	$ (0.15)	$ (0.14)	$ (0.47)	$ (0.34)
Shares used in computing basic and diluted net loss per common share	12,317,992	12,307,089	12,316,773	12,254,753

See accompanying notes to the condensed consolidated financial statements

NEPHROS, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)

	Nine Months Ended September 30, 2006	2005
Operating activities:		
Net loss	$ (5,758,375)	$ (4,173,102)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation	224,250	229,828
Loss on disposal of equipment	24,293	-
Amortization of debt discount	3,939	-
Noncash stock-based compensation	453,693	326,458
(Increase) decrease in operating assets:		
Accounts receivable	(181,076)	(54,813)
Inventory	387,087	184,445
Prepaid expenses and other current assets	(490)	(248,800)
Increase (decrease) in operating liabilities:		
Accounts payable and accrued expenses	(614,736)	267,987
Accrued severance expense	(335,402)	-
Accrued interest-convertible notes	103,430	-
Deferred revenue	-	(64,058)
Net cash used in operating activities	(5,693,387)	(3,532,055)
Investing activities		
Purchase of property and equipment	(32,776)	(228,990)
Purchase of short-term investments	(3,000,000)	-
Maturities of short-term investments	3,700,000	-
Net cash provided by (used in) investing activities	667,224	(228,990)
Financing activities		
Proceeds from private placement of common stock	-	955,521
Proceeds from private placement of convertible notes	5,206,921	-
Adjustment to proceeds from IPO of common stock	-	44,361
Proceeds from exercise of stock options	1,441	1,439
Net cash provided by financing activities	5,208,362	1,001,321
Effect of exchange rates on cash	(4,824)	(130,514)
Net increase (decrease) in cash and cash equivalents	177,375	(2,890,238)
Cash and cash equivalents, beginning of period	746,581	3,719,181
Cash and cash equivalents, end of period	$ 923,957	$ 828,943

Supplemental disclosure of cash flow information				
Cash paid for taxes	$	32,283	$	11,630

See accompanying notes to the condensed consolidated financial statements

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NEPHROS, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY
(unaudited)

	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Deferred Compensation	Accumulated Other Comprehensive Loss	Accumulated Deficit	Total
Balance, December 31, 2005	12,313,494	$ 12,313	$ 54,848,711	$ (2,189,511)	$ (49,137)	$ (47,242,883)	$ 5,379,493
Comprehensive loss:							
Net loss						(5,758,375)	(5,758,375)
Net unrealized losses on foreign currency translation					12,443		12,443
Comprehensive loss							(5,745,932)
Reclassification of deferred compensation			(2,189,511)	2,189,511			-
Noncash stock-based compensation			453,693				453,693
Exercise of stock options	4,498	5	1,436				1,441
Balance, September 30, 2006	12,317,992	$ 12,318	$ 53,114,329	$ -	$ (36,694)	$ (53,001,259)	$ 88,694

See accompanying notes to the condensed consolidated financial statements

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NEPHROS, INC. AND SUBSIDIARY

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
For the periods ended September 30, 2006 and 2005
(unaudited)

1. Basis of Presentation and Going Concern

The accompanying unaudited condensed consolidated financial statements of Nephros, Inc. and its wholly owned subsidiary, Nephros International, Limited, (together the "Company") should be read in conjunction with the audited financial statements and notes thereto included in the Company's 2005 Annual Report on Form 10-KSB filed with the Securities and Exchange Commission (the "SEC") on April 20, 2006. The accompanying 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-QSB. Accordingly, since they are interim statements, the accompanying financial statements do not include all of the information and notes required by GAAP for a complete financial statement presentation. In the opinion of management, the interim 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 interim periods presented. Interim results are not necessarily indicative of results for a full year. All inter-company transactions have been eliminated in consolidation. Accrued severance expense as of December 31, 2005 was reclassified from total accrued expenses and presented separately on the balance sheet to be consistent with the current period presentation.

For the nine months ended September 30, 2006 and 2005, the following customers accounted for the following percentages of the Company's sales, respectively. The Company believes that the loss of any of these customers could have a material adverse effect on the Company's product sales, at least temporarily, while the Company seeks to replace such customers and/or self-distribute in the territories currently served by such customers.

Customer	2006	2005
A	63%	41%
B	20%	3%

As of September 30, 2006 and 2005, the following customers accounted for the following percentages of the Company's accounts receivable, respectively. The Company believes that the loss of these customers could have a material adverse effect on the Company's product sales, at least temporarily, while the Company seeks to replace such customers and/or self-distribute in the territories currently served by such customers.

Customer	2006	2005
A	71%	65%
C	12%	11%

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 raises 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, and in order to comply with the American Stock Exchange's continued listing standards, the Company will need to raise additional funds through either the licensing of its technologies or the additional public or private offerings of its securities. However, there is no guarantee that the

Company will be able to obtain further financing. If the Company is unable to raise additional funds on a timely basis or at all, the Company would be adversely affected. The Company is exploring various options in respect of raising additional funds.

2. Stock Based Compensation

The Company has adopted Statement of Financial Accounting Standards ("SFAS") No. 123 (Revised 2004), "Share-Based Payment" ("SFAS 123R"), effective January 1, 2006. SFAS 123R requires the recognition of compensation expense in an amount equal to the fair value of all share-based payments granted to employees. The Company has elected the modified prospective transition method and therefore adjustments to prior periods are not required as a result of adopting SFAS 123R. Under this method, the provisions of SFAS 123R apply to all awards granted after the date of adoption and to any unrecognized expense of awards unvested at the date of adoption based on the grant date fair value. SFAS 123R also amends SFAS No. 95, "Statement of Cash Flows," to require that excess tax benefits that had been reflected as operating cash flows be reflected as financing cash flows. Deferred compensation of $2,189,511 related to the awards granted in periods prior to January 1, 2006 were reclassified against additional paid-in capital, as required by SFAS 123R.

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 and vest upon a combination of the following: immediate vesting; straight line vesting of two, three, or four years; and upon the achievement of certain milestones.

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 recognized. Stock based compensation expense recognized for the three and nine months ended September 30, 2006 was approximately $80,616 or $0.01 per share and $453,693 or $0.04 per share, respectively.

Fair values for the first nine months of 2006 and 2005 were estimated using the Black-Scholes option-pricing model, based on the following assumptions:

	Nine Months Ended September 30,	
	2006	**2005**
Expected volatility	65% to 92%	80%
Risk-free interest rate	4.3% to 5.0%	4.0%
Expected life of options (in years)	5.8 to 6.0	7.0

There is no expected dividend yield. 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 grant's life.

Stock-based employee compensation for the three and nine months ended September 30, 2005 was determined using the intrinsic value method. The following table provides supplemental information for the three and nine months ended September 30, 2005 as if stock-based compensation had been computed under SFAS 123:

	Three Months Ended September 30, 2005	**NineMonths Ended September30, 2005**
Net loss as reported	$ (1,747,882)	$ (4,173,102)
Add back: compensation expense recorded under the intrinsic method	35,566	326,458

Deduct: compensation expense under the fair value method		(161,862)		(675,728)
Pro forma net loss using the fair value method	$	(1,874,178)	$	(4,522,372)
Net loss per share:				
As reported	$	(0.14)	$	(0.34)
Pro forma	$	(0.15)	$	(0.37)

The Company granted stock options to purchase an aggregate of 650,500 shares of common stock during the nine-month period ended September 30, 2006. The weighted average fair value per share of the stock options granted in the nine-month period ended September 30, 2006 was $1.14. The Company granted stock options to purchase an aggregate of 450,000 share of common stock in the three-month period ended September 30, 2006. The weighted average fair value per share of the stock options granted in the three-month period ended September 30, 2006 was $0.97. The Company granted 65,000 stock options in the nine-month period ended September 30, 2005. The weighted average fair value per share of the stock options granted in the nine-month period ended September 30, 2005 was $2.00. The Company did not grant any stock options in the three-month period ended September 30, 2005.

The total fair value of options vested during the three and nine-month periods ended September 30, 2006, was $54,563 and $389,036 respectively. Such amounts are recorded in selling, general and administrative expense and research and development. As of September 30, 2006, the total remaining unrecognized compensation cost related to non-vested stock options amounted to $1,887,304. Of this amount, $640,643 will be amortized over the weighted-average remaining requisite service period of 1.7 years and $1,246,661will be recognized upon the attainment of related milestones.

The following table summarizes stock option activity for the nine-month period ended September 30, 2006:

	Number of options		Weighted Average Exercise Price
At January 1, 2006	1,884,537	$	1.91
Granted	650,500		1.14
Exercised	(4,498)		0.32
Canceled or expired	(202,573)		2.65
Outstanding at September 30, 2006	2,327,966	$	1.75
Exercisable at September 30, 2006	1,387,611	$	1.54

The aggregate intrinsic value of stock options outstanding at September 30, 2006 was $355,591. The aggregate intrinsic value of stock options currently exercisable at September 30, 2006 was $355,591. Intrinsic value for stock options is calculated based on the exercise price of the underlying awards as compared to the quoted price of the Company's common stock as of the reporting date. There were no tax benefits recognized related to stock-based compensation and related cash flow impacts during the first nine months of 2006, as the Company is in a net operating loss position.

3. Loss per Common Share

In accordance with SFAS No. 128, "Earnings Per Share," net loss per common share amounts ("basic EPS") were computed by dividing net loss by the weighted-average number of common shares outstanding and excluding any potential dilution. Net loss per common share amounts assuming dilution ("diluted EPS") are 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 where basic EPS is negative, the Company has excluded stock options and warrants exercisable to purchase in the aggregate 2,719,732 common shares from the computation of diluted EPS for each of the three and nine month periods ended September 30, 2006 and 2,310,359 common shares for each of the three and nine month periods ended September 30, 2005.

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NEPHROS, INC. AND SUBSIDIARY

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
For the periods ended September 30, 2006 and 2005 (unaudited)
(continued)

4. Inventory

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, 2006 and December 31, 2005 was as follows:

	September 30, 2006	December 31, 2005
Raw Materials	$ 187,006	$ 153,299
Finished Goods	276,436	661,249
Total Inventory	$ 463,442	$ 814,548

5. Convertible Notes due 2012

In June 2006, the Company entered into subscription agreements with certain investors who purchased an aggregate of $5,200,000 principal amount of 6% Secured Convertible Notes due 2012 (the "Notes") issued by the Company for the face value thereof. The Company closed on the sale of the first tranche of Notes, in an aggregate principal amount of $5,000,000, on June 1, 2006 (the "First Tranche") and closed on the sale of the second tranche of Notes, in an aggregate principal amount of $200,000, on June 30, 2006 (the "Second Tranche"). The Notes are secured by substantially all of the Company's assets.

The Notes accrue interest at a rate of 6% per annum, compounded annually and payable in arrears at maturity. Subject to certain restrictions, principal and accrued interest on the Notes are convertible at any time at the holder's option into shares of the Company's common stock, at an initial conversion price of $2.10 per share (subject to anti-dilution adjustments upon the occurrence of certain events). There is no cap on any increases to the conversion price. The conversion price may not be adjusted to an amount less than $0.001 per share, the current par value of the Company's common stock. The Company may cause the Notes to be converted at their then effective conversion price, if the common stock achieves average last sales prices of at least 240% of the then effective conversion price and average daily volume of at least 35,000 shares (subject to adjustment) over a prescribed time period. In the case of an optional conversion by the holder or a compelled conversion by the Company, the Company has 15 days from the date of conversion to deliver certificates for the shares of common stock issuable upon such conversion. As further described below, conversion of the Notes is restricted, pending stockholder approval.

The Company may prepay outstanding principal and interest on the Notes at any time. Any prepayment requires the Company to pay each holder a premium equal to 15% of the principal amount of the Notes held by such holder receiving the prepayment if such prepayment is made on or before June 1, 2008, and 5% of the principal amount of the Notes held by such holder receiving prepayment in connection with prepayments made thereafter. In addition to the applicable prepayment premium, upon any prepayment of the Notes occurring on or before June 1, 2008, the Company must issue the holder of such Notes warrants ("Prepayment Warrants") to purchase a quantity of common stock equal to three shares for every $20 principal amount of Notes prepaid at an exercise price of $0.01 per share (subject to adjustment). Upon issuance, the Prepayment Warrants would expire on June 1, 2012.

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NEPHROS, INC. AND SUBSIDIARY

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
For the periods ended September 30, 2006 and 2005 (unaudited)
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Unless and until its stockholders approve the issuance of shares of common stock in excess of such amount, the number of shares of common stock issuable upon conversion of the First Tranche of Notes and exercise of the Prepayment Warrants related thereto, in the aggregate, is limited to 2,451,280 shares, which equals approximately 19.9% of the number of shares of common stock outstanding immediately prior to the issuance of the Notes. The Company will not issue any shares of common stock upon conversion of the Second Tranche of Notes or exercise of any Prepayment Warrants that may be issued pursuant to such Notes until its stockholders approve the issuance of shares of common stock upon conversion of the Notes and exercise of the Prepayment Warrants as may be required by the applicable rules and regulations of the American Stock Exchange (the “AMEX”).

In connection with the sale of the Notes, the Company has entered into a registration rights agreement with the investors pursuant to which the Company granted the investors two demand registration rights and unlimited piggy-back and short-form registration rights with respect to the shares of common stock issuable upon conversion of the Notes or exercise of Prepayment Warrants, if any.

Subject to terms and conditions set forth in the Notes, the outstanding principal of and accrued interest on the Notes may become immediately due and payable upon the occurrence of any of the following events of default: the Company’s failure to pay principal or interest on the Notes when due; certain bankruptcy-related events with respect to the Company; material breach of any representation, warranty or certification made by the Company in or pursuant to the Notes, or under the registration rights agreement or the subscription agreements; its incurrence of Senior Debt (as defined in the Notes); the acceleration of certain of the Company’s other debt; or the rendering of certain judgments against the Company.

The Notes contain a prepayment feature that requires the Company to issue common stock purchase warrants to the Note holders for partial consideration of certain Note prepayments that the Note holders may demand under certain circumstances. Pursuant to the Notes, the Company must offer the Note holders the option (the “Holder Prepayment Option”) of prepayment (subject to applicable premiums) of their Notes, if the Company completes an asset sale in excess of $250,000 outside the ordinary course of business (a “Major Asset Sale”), to the extent of the net cash proceeds of such Major Asset Sale. Paragraph 12 of SFAS No. 133, “Accounting for Derivative Instruments and Hedging Activities”, (“SFAS 133”), provides that an embedded derivative shall be separated from the host contract and accounted for as a derivative instrument if and only if certain criteria are met. In consideration of SFAS 133, the Company has determined that the Holder Prepayment Option is an embedded derivative to be bifurcated from the Notes and carried at fair value in the financial statements. At June 1, 2006 the value of the embedded derivative was a liability of approximately $71,000. The Company reassesses the valuation of the Holder Prepayment Option quarterly.

At September 30, 2006, the value of the embedded derivative was a liability of approximately $78,000. The change in value was recorded as other expense during the quarter. Also, the debt discount, of approximately $71,000, created by bifurcating the Holder Prepayment Option, is being amortized over the term of the debt. During the quarter ended September 30, 2006, the Company recorded interest expense of approximately $4,000.

6. Commitments and Contingencies

Settlement Agreements

In April 2002, the Company entered into a letter agreement with Hermitage Capital Corporation ("Hermitage"), as placement agent, the stated term of which was from April 30, 2002 through September 30, 2004. As of February 2003, the Company entered into a settlement agreement with Hermitage pursuant to which, among other things: the letter agreement was terminated; the parties gave mutual releases relating to the letter agreement, and the Company agreed to issue Hermitage or its designees, upon the closing of certain transactions contemplated by a separate settlement agreement between the Company and Lancer Offshore, Inc. (“Lancer”), warrants exercisable until February 2006 to purchase an aggregate of 60,000 shares of common stock for $2.50 per share (or 17,046 shares of the Company’s common stock for $8.80 per share, adjusted for the reverse stock split effected by the Company on September 10, 2004, pursuant to the antidilution provisions of such warrant, as amended.) Because Lancer never satisfied the closing conditions and, consequently, a closing has not been held, the Company has not issued any warrants to Hermitage in connection with the Company’s settlement with them. In June 2004, Hermitage threatened to sue the Company for warrants it claimed were due to it under its settlement agreement with the Company as well as a placement fee and additional warrants it claimed were, or would be, owed in connection with the Company’s initial public offering completed on September 24, 2004, as compensation for allegedly introducing the Company to one of the underwriters. The Company had some discussions with Hermitage in the hopes of reaching an amicable resolution of any potential claims, most recently in January 2005. The Company has not heard from Hermitage since then. As of September 30, 2006, no loss amount has been accrued because a loss is not considered probable or estimable.

In June 2002, the Company entered into a settlement agreement with one of its suppliers. The Company had an outstanding liability to such supplier in the amount of approximately $1,900,000. Pursuant to this settlement agreement, the Company and the supplier agreed to release each other from any and all claims or liabilities, whether known or unknown, that each had against the other as of the date of the settlement agreement, except for obligations arising out of the settlement agreement itself. The settlement agreement required the Company to grant to the supplier (i) warrants to purchase 170,460 shares of common stock of the Company at an exercise price of approximately $10.56 per share that expire in June 2007 and (ii) cash payments of an aggregate amount of $650,000 in three installments. The warrants were valued at $400,000 using the Black-Scholes model. Accordingly, the Company recorded a gain of approximately $850,000 based on such settlement agreement. On June 19, 2002, the Company issued the warrant to the supplier, and on August 7, 2002, the Company satisfied the first $300,000 installment of the agreement. The second installment of $100,000 was due on February 7, 2003, and the Company paid $75,000 towards the installment. On November 11, 2004, after the successful closing of its initial public offering, the Company paid an additional $25,000 and agreed with the supplier to pay the remaining $250,000 over time. The outstanding balance at September 30, 2006 was $100,000 and is included in “Accounts Payable” on the condensed consolidated balance sheet. As agreed with the supplier, the Company will retire the remaining balance by making four quarterly payments each in the amount of $25,000.

In August 2002, the Company entered into a subscription agreement with Lancer. The subscription agreement provided, among other things, that Lancer would purchase, in several installments, (1) $3,000,000 principal amount of secured notes due March 15, 2003 convertible into 340,920 shares of the Company’s common stock and (2) warrants to purchase until December 2007 an aggregate of 68,184 shares of the Company’s common stock at an exercise price of approximately $8.80 per share. In accordance with the subscription agreement, the first installment of securities, consisting of $1,500,000 principal amount of the notes and 34,092 of the warrants (which 34,092 warrants had nominal value at such time), were tendered. However, Lancer failed to fund the remaining installments. Following this failure, the Company entered into a settlement agreement with Lancer dated as of January 31, 2003, pursuant to which, (i) the parties terminated the subscription agreement; (ii) Lancer agreed to surrender 12,785 of the original 34,092 warrants issued to it; (iii) the warrants that were not surrendered were amended to provide that the exercise price per share and the number of shares issuable upon exercise thereof would not be adjusted as a result of a 0.2248318-for one reverse stock split of the Company’s common stock that was contemplated at such time but never consummated; and (iv) the secured convertible note in the principal amount of $1,500,000 referred to above was cancelled. Lancer agreed, among other things, to deliver to the Company at or prior to a subsequent closing the cancelled note and warrants and to reaffirm certain representations and warranties and, subject to the satisfaction of these and other conditions, the Company agreed to issue to Lancer at such subsequent closing an unsecured note in the principal amount of $1,500,000 bearing no interest, not convertible into common stock and due on January 31, 2004 or earlier under certain circumstances. Lancer never fulfilled the conditions to the subsequent closing and, accordingly, the Company never issued the $1,500,000 note that the settlement agreement provided would be issued at such closing.

NEPHROS, INC. AND SUBSIDIARY

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(continued)

The above transaction resulted in the Company becoming a defendant in an action captioned Marty Steinberg, Esq. as Receiver for Lancer Offshore, Inc. v. Nephros, Inc., Case No. 04-C V-20547, that was commenced on March 8, 2004, in the U.S. District Court for the Southern District of Florida (the “Ancillary Proceeding”). That action was ancillary to a proceeding captioned Securities and Exchange Commission v. Michael Lauer, et. al., Case No.03-CV-80612, pending in the U.S. District Court for the Southern District of Florida, in which the court had appointed a Receiver to manage Lancer and various related entities (the “Receivership”). In the Ancillary Proceeding, the Receiver sought payment of $1,500,000, together with interest, costs and attorneys’ fees, as well as delivery of a warrant evidencing the right to purchase until December 2007 an aggregate of 75,000 shares of the Company’s common stock for $2.50 per share (or 21,308 shares of the Company’s common stock for $8.80 per share, if adjusted for the 0.2841-for-one reverse stock split the Company effected on September 10, 2004 pursuant to the antidilution provisions of such warrant, as amended). On or about April 29, 2004, the Company served an answer in which it denied liability for, and asserted numerous defenses to, the Receiver’s claims. In addition, on or about March 30, 2004, the Company asserted claims for damages against Lancer Offshore, Inc. that exceeded the amount sought in the Ancillary Proceeding by submitting a proof of claim in the Receivership.

On December 19, 2005, the U.S. District Court for the Southern District of Florida approved the Stipulation of Settlement with respect to the Ancillary Proceeding dated November 8, 2005 (the “Settlement”). Pursuant to the terms of the Settlement, the Company agreed to pay the Receiver an aggregate of $900,000 under the following payment terms: $100,000 paid on January 5, 2006; and four payments of $200,000 each at six month intervals thereafter. In addition, any warrants previously issued to Lancer were cancelled, and, on January 18, 2006, the Company issued to the Receiver warrants to purchase 21,308 shares of the Company’s common stock at $1.50 per share exercisable until January 18, 2009.

The Company had reserved for the Ancillary Proceeding on its balance sheet as of December 31, 2004 as a $1,500,000 accrued liability. As a result of the above Settlement the Company has adjusted such accrued liability and recorded a note payable to the Receiver to reflect the present value, as of September 30, 2006, of the above amounts due to the Receiver of $563,727, of which $379,702 is reflected as short-term note payable and $184,025 reflected as a long-term note payable. Additionally, the Company recorded the issuance of the warrants issued at their fair market value of $17,348 based on a Black-Scholes calculation. Such Settlement resulted in a gain of $623,087 recorded in the fourth quarter of 2005.

Employee Severance Agreement

During the year ended December 31, 2005, the Company expensed $318,250 for severance costs associated with the termination of the employment of Jan Rehnberg, our former Senior Vice President, Marketing and Sales. These severance expenses were reported within accrued expenses and presented as accrued severance expenses at December 31, 2005. In accordance with the terms and provisions of his employment agreement, the Company paid a lump sum severance payment of $253,856 of the balance to Mr. Rehnberg on April 19, 2006. During the three months ended September 30, 2006, the Company reversed the $64,394 residual portion of the severance accrual as it was determined during the quarter that this liability was no longer required.

7. Notification from the American Stock Exchange

On July 17, 2006, the Company received notice from the staff of the AMEX that, based on AMEX’s review of the Company’s Form 10-QSB for the quarter ended March 31, 2006, the Company is not in compliance with certain conditions of the continued listing standards of Section 1003 of the AMEX Company Guide. Specifically, AMEX noted the Company’s failure to comply with Section 1003(a)(ii) relating to shareholders’ equity of less than $4,000,000 and losses from continuing operations and/or net losses in three of the Company’s four most recent fiscal years and Section 1003(a)(iii) relating to shareholders’ equity of less than $6,000,000 and losses from continuing operations and/or net losses in the Company’s five most recent fiscal years.

NEPHROS, INC. AND SUBSIDIARY

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
For the periods ended September 30, 2006 and 2005 (unaudited)
(continued)

In order to maintain listing of the Company’s common stock on AMEX, the Company submitted a plan on August 23, 2006 advising AMEX of the actions the Company has taken, or will take, that would bring the Company into compliance with the applicable listing standards by January 17, 2008. On November 14, 2006, the AMEX notified the Company that the AMEX will continue the Company’s listing, subject to certain conditions which are substantially as follows. First, the Company must make a public announcement through the news media by November 21, 2006, disclosing the fact that it is not in compliance with the AMEX’s continued listing standards and that its listing is being continued pursuant to an extension. Second, during the plan period, the Company must continue to provide the AMEX Staff with updates regarding initiatives set forth in its plan of compliance. Finally, if the Company is not in compliance with the continued listing standards at January 17, 2008 or the Company does not make progress consistent with the plan during the plan period, then the AMEX may initiate immediate delisting proceedings.

As of the date of this filing, the Company’s common stock continues to trade on AMEX under the symbol NEP.