SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2006

OR

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

For the transition period from to

Commission file number 0-32501

CYTORI THERAPEUTICS, INC.

(Exact name of Registrant as Specified in Its Charter)

DELAWARE	**33-0827593**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
3020 CALLAN ROAD, SAN DIEGO, CALIFORNIA	**92121**
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: **(858) 458-0900**

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 ☒ No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer" and "large accelerated filer" in Rule 12b-2 of the Exchange Act. Large Accelerated Filer o Accelerated Filer o Non-Accelerated Filer ☒

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

As of October 31, 2006, there were 18,722,735 shares of the registrant's common stock outstanding.

CYTORI THERAPEUTICS, INC.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
Cytori Therapeutics, Inc.:

We have reviewed the accompanying consolidated condensed balance sheet of Cytori Therapeutics, Inc. and subsidiaries (the Company) as of September 30, 2006, the related consolidated condensed statements of operations and comprehensive loss for the three and nine month periods ended September 30, 2006, and the statements of cash flows for the nine-month periods ended September 30, 2006 and 2005. These consolidated condensed financial statements are the responsibility of the Company's management.

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

Based on our review, we are not aware of any material modifications that should be made to the consolidated condensed financial statements referred to above for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Cytori Therapeutics, Inc. and subsidiaries as of December 31, 2005, and the related consolidated statements of operations and comprehensive loss, stockholders' deficit, and cash flows for the year then ended (not presented herein); and in our report dated March 24, 2006, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated condensed balance sheet as of December 31, 2005, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

Note 1 of the Company's audited financial statements as of December 31, 2005 and for the year then ended discloses that the Company derives a substantial portion of its revenues from a related party. Our auditors' report on those financial statements dated March 24, 2006, includes an explanatory paragraph referring to the matter in note 1 of those consolidated financial statements.

/s/ KPMG, LLP

San Diego, California
November 14, 2006

CYTORI THERAPEUTICS, INC.
CONSOLIDATED CONDENSED BALANCE SHEETS
(UNAUDITED)

	As of September 30, 2006	As of December 31, 2005
Assets		
Current assets:		
Cash and cash equivalents	$ 13,615,000	$ 8,007,000
Short-term investments, available-for-sale	4,834,000	7,838,000
Accounts receivable, net of allowance for doubtful accounts of $1,000 and $9,000 in 2006 and 2005, respectively	103,000	816,000
Inventories, net	210,000	258,000
Other current assets	781,000	621,000
Total current assets	19,543,000	17,540,000
Property and equipment held for sale, net	457,000	675,000
Property and equipment, net	4,578,000	3,585,000
Investment in joint venture	82,000	—
Other assets	453,000	458,000
Intangibles, net	1,355,000	1,521,000
Goodwill	4,387,000	4,387,000
Total assets	$ 30,855,000	$ 28,166,000
Liabilities and Stockholders' Deficit		
Current liabilities:		
Accounts payable and accrued expenses	$ 4,850,000	$ 6,129,000
Current portion of long-term obligations	886,000	952,000
Total current liabilities	5,736,000	7,081,000
Deferred revenues, related party	29,128,000	17,311,000
Deferred revenues	2,392,000	2,541,000
Option liabilities	1,817,000	5,331,000
Long-term deferred rent	831,000	573,000
Long-term obligations, less current portion	910,000	1,558,000
Total liabilities	40,814,000	34,395,000
Commitments and contingencies		
Stockholders' deficit:		
Preferred stock, $0.001 par value; 5,000,000 shares authorized; -0- shares issued and outstanding in 2006 and 2005	—	—
Common stock, $0.001 par value; 95,000,000 shares authorized; 21,475,506 and 18,194,283 shares issued and 18,602,672 and 15,321,449 shares outstanding in 2006 and 2005, respectively	21,000	18,000
Additional paid-in capital	102,016,000	82,196,000
Accumulated deficit	(101,548,000)	(78,013,000)
Treasury stock, at cost	(10,414,000)	(10,414,000)
Accumulated other comprehensive loss	(34,000)	(16,000)
Total stockholders' deficit	(9,959,000)	(6,229,000)
Total liabilities and stockholders' deficit	$ 30,855,000	$ 28,166,000

SEE NOTES TO UNAUDITED CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

CYTORI THERAPEUTICS, INC.
CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS
(UNAUDITED)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2006	2005	2006	2005
Product revenues, related party	$ 133,000	$ 1,544,000	$ 1,087,000	$ 4,776,000
Cost of product revenues	383,000	928,000	1,341,000	2,411,000
Gross (loss) profit	(250,000)	616,000	(254,000)	2,365,000
Development revenues:				
Development	1,000	11,000	832,000	20,000
Research grant and other	350,000	27,000	413,000	116,000
Total development revenues	351,000	38,000	1,245,000	136,000
Operating expenses:				
Research and development	5,552,000	3,991,000	16,749,000	10,573,000
Sales and marketing	610,000	479,000	1,584,000	1,207,000
General and administrative	3,181,000	3,129,000	10,005,000	7,486,000
Change in fair value of option liabilities	(374,000)	924,000	(3,514,000)	984,000
Total operating expenses	8,969,000	8,523,000	24,824,000	20,250,000
Operating loss	(8,868,000)	(7,869,000)	(23,833,000)	(17,749,000)
Other income (expense):				
Interest income	158,000	99,000	537,000	208,000
Interest expense	(47,000)	(31,000)	(158,000)	(107,000)
Other expense, net	(7,000)	(13,000)	(13,000)	(52,000)
Equity loss from investment in joint venture	(3,000)	—	(68,000)	—
Gain on sale of assets	—	5,526,000	—	5,526,000
Total other income	101,000	5,581,000	298,000	5,575,000
Net loss	(8,767,000)	(2,288,000)	(23,535,000)	(12,174,000)
Other comprehensive income (loss)- unrealized income (loss)	6,000	(5,000)	(18,000)	9,000
Comprehensive loss	$ (8,761,000)	$ (2,293,000)	$ (23,553,000)	$ (12,165,000)
Basic and diluted net loss per common share	$ (0.53)	$ (0.15)	$ (1.48)	$ (0.84)
Basic and diluted weighted average common shares	16,641,423	15,177,020	15,891,674	14,512,898

SEE NOTES TO UNAUDITED CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

CYTORI THERAPEUTICS, INC.
CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	For the Nine Months Ended September 30,	
	2006	**2005**
Cash flows from operating activities:		
Net loss	$ (23,535,000)	$ (12,174,000)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,605,000	1,290,000
Inventory provision	70,000	178,000
(Reduction in) addition to allowance for doubtful accounts	(5,000)	1,000
Change in fair value of option liabilities	(3,514,000)	984,000
Stock-based compensation expense	2,652,000	404,000
Stock issued for license amendment, related party	487,000	—
Equity loss from investment in joint venture	68,000	—
Gain on sale of assets	—	(5,526,000)
Increases (decreases) in cash caused by changes in operating assets and liabilities:		
Accounts receivable	718,000	(21,000)
Inventories	(22,000)	(61,000)
Other current assets	(160,000)	200,000
Other assets	5,000	(206,000)
Accounts payable and accrued expenses	(1,766,000)	1,646,000
Deferred revenues, related party	11,817,000	7,811,000
Deferred revenues	(149,000)	(20,000)
Long-term deferred rent	258,000	—
Net cash used in operating activities	(11,471,000)	(5,494,000)
Cash flows from investing activities:		
Proceeds from sale and maturity of short-term investments	53,264,000	36,788,000
Purchases of short-term investments	(50,278,000)	(33,484,000)
Purchases of property and equipment	(2,214,000)	(1,052,000)
Investment in joint venture	(150,000)	—
Net cash provided by investing activities	622,000	2,252,000
Cash flows from financing activities:		
Principal payments on long-term obligations	(714,000)	(719,000)
Proceeds from exercise of employee stock options and warrants	819,000	207,000
Proceeds from sale of common stock	16,352,000	3,003,000
Proceeds from issuance of options	—	186,000
Net cash provided by financing activities	16,457,000	2,677,000
Net increase (decrease) in cash and cash equivalents	5,608,000	(565,000)
Cash and cash equivalents at beginning of period	8,007,000	2,840,000
Cash and cash equivalents at end of period	$ 13,615,000	$ 2,275,000
Supplemental disclosure of cash flows information:		
Cash paid during period for:		
Interest	$ 160,000	$ 112,000
Taxes	1,000	16,000

SEE NOTES TO UNAUDITED CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

CYTORI THERAPEUTICS, INC.
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
SEPTEMBER 30, 2006
(UNAUDITED)

1. Basis of Presentation

Our accompanying unaudited consolidated condensed financial statements as of September 30, 2006 and for the three and nine months ended September 30, 2006 and 2005 have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for annual financial statements. Our consolidated condensed balance sheet at December 31, 2005 has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation of the financial position and results of operations of Cytori Therapeutics, Inc., and our subsidiaries, have been included. Operating results for the three and nine months ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. For further information, refer to our consolidated financial statements for the year ended December 31, 2005 and footnotes thereto which were included in our Annual Report on Form 10-K, dated March 30, 2006.

Certain prior period amounts have been reclassified to conform to the current period presentation. In particular, effective January 1, 2006, we have presented the expense related to our stock-based compensation programs in the same lines as we classify cash compensation paid to the recipient employees. These expenses were shown as a separate line item in the prior year. See note 5 below for further details.

2. Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions affecting the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from these estimates. Estimates and assumptions are reviewed periodically, and the effects of revisions are reflected in the consolidated financial statements in the periods they are determined to be necessary.

Our most significant estimates and critical accounting policies involve revenue recognition, evaluating goodwill and long-lived assets for impairment, accounting for product line dispositions, and determining the fair value of stock options.

3. Segment Information

On July 11, 2005, we announced the reorganization of our business based on two distinct operating segments - (a) Regenerative cell technology and (b) MacroPore Biosurgery, which manufactures bioresorbable implants. In the past, our resources were managed on a consolidated basis. However, in an effort to better reflect our focus and significant progress in the development of regenerative therapies, we are now evaluating and therefore reporting our financial results in two segments.

Our regenerative cell technology segment is focused on the discovery and development of cell-based therapies for cardiovascular disease, spine and orthopedic conditions, gastrointestinal disorders and new approaches for aesthetic and reconstructive surgery using regenerative cells from adipose tissue, also known as fat tissue. Our MacroPore Biosurgery unit manufactures and distributes the HYDROSORB™ family of FDA-cleared bioresorbable spine and orthopedic implants; it also develops Thin Film bioresorbable implants for sale in Japan through Senko Medical Trading Company (“Senko”), which has exclusive distribution rights to these products in Japan.

We measure the success of each operating segment based on operating results and, additionally, in the case of the regenerative cell technology segment, the achievement of key research objectives. In arriving at our operating results for each segment, we use the same accounting policies as those used for our consolidated company and as described throughout this note. However, segment operating results exclude allocations of company-wide general and administrative costs, and changes in fair value of our option liabilities.

Prior year results presented below have been developed on the same basis as the current year figures. For all periods presented, we did not have any intersegment transactions.

The following tables provide information regarding the performance and assets of our operating segments:

	For the three months ended September 30,		For the nine months ended September 30,	
	2006	2005	2006	2005
Revenues:				
Regenerative cell technology	$ 350,000	$ 27,000	$ 1,096,000	$ 116,000
MacroPore Biosurgery	134,000	1,555,000	1,236,000	4,796,000
Total revenues	$ 484,000	$ 1,582,000	$ 2,332,000	$ 4,912,000
Segment losses:				
Regenerative cell technology	$ (5,491,000)	$ (3,515,000)	$ (16,006,000)	$ (8,570,000)
MacroPore Biosurgery	(570,000)	(301,000)	(1,336,000)	(709,000)
General and administrative expenses	(3,181,000)	(3,129,000)	(10,005,000)	(7,486,000)
Change in fair value of option liabilities	374,000	(924,000)	3,514,000	(984,000)
Total operating loss	$ (8,868,000)	$ (7,869,000)	$ (23,833,000)	$ (17,749,000)

	As of September 30, 2006	As of December 31, 2005
Assets:		
Regenerative cell technology	$ 7,350,000	$ 9,591,000
MacroPore Biosurgery	1,264,000	2,207,000
Corporate assets	22,241,000	16,368,000
Total assets	$ 30,855,000	$ 28,166,000

4. Assets Held for Sale

We are developing applications for stem cells, residing naturally in adipose (fat) tissue, for acute myocardial infarction, chronic ischemia, and for use in reconstructive surgery. We have begun to focus our efforts exclusively on the regenerative cell therapy segment of our business. As a result, our Board of Directors has decided to divest and is actively seeking a buyer (or buyers) for our remaining MacroPore Biosurgery assets as a means to fund our continuing efforts in this segment. This decision is based on the change in our strategic focus as well as the continuing negative profit margins being realized from the MacroPore Biosurgery segment. We expect to complete the disposal no later than the third quarter of 2007. As of September 30, 2006, the remaining assets were comprised of machinery and equipment used for manufacturing, with a net book value of $457,000.

5. Stock-Based Compensation

Accounting Policy

On January 1, 2006, we adopted the provisions of Financial Accounting Standards Board Statement No. 123R, “Share-Based Payment” (“SFAS 123R”) using the modified prospective transition method. SFAS 123R requires us to measure all share-based payment awards granted after (or that were unvested as of) January 1, 2006, including those with employees, at fair value. Under SFAS 123R, the fair value of stock options and other equity-based compensation must be recognized as expense in the statements of operations over the requisite service period of each award.

Beginning January 1, 2006, we have recognized compensation expense under SFAS 123R for the unvested portions of outstanding share-based awards previously granted under our (a) 2004 Equity Incentive Plan and (b) 1997 Stock Option and Stock Purchase Plan, over the periods these awards continue to vest. This compensation expense is recognized based on the fair values and attribution methods that were previously disclosed in our prior period financial statements under SFAS No. 123.

Prior to January 1, 2006, we applied the intrinsic value-based method of accounting for share-based payment transactions with our employees, as prescribed by Accounting Principles Board (“APB”) Opinion No. 25, “Accounting for Stock Issued to Employees,” and related interpretations including Financial Accounting Standards Board (“FASB”) Interpretation No. 44, “Accounting for Certain Transactions Involving Stock Compensation-An Interpretation of APB Opinion No. 25.” Under the intrinsic value method, compensation expense was recognized only if the current market price of the underlying stock exceeded the exercise price of the share-based payment award as of the measurement date (typically the date of grant). Statement of Financial Accounting Standards No. 123, “Accounting for Stock-Based Compensation,” established accounting and disclosure requirements using a fair value-based method of accounting for stock-based employee compensation plans. As permitted by SFAS 123 and by Statement of Financial Accounting Standards No. 148, “Accounting for Stock-Based Compensation—Transition and Disclosure,” we disclosed on a pro forma basis the net income and earnings per share that would have resulted had we adopted SFAS 123 for measurement purposes.

No stock options were granted during the three months ended September 30, 2005.

Fair value under SFAS No. 123 is determined using the Black-Scholes option-pricing model with the following assumptions:

	For the nine months ended September 30, 2005
Expected term	6 years
Risk free Interest rate	3.86-4.16%
Volatility	81.40-82.67%
Dividends	—
Resulting weighted average grant date fair value	$ 2.27

Had compensation expense been recognized for stock-based compensation plans in accordance with SFAS 123, we would have recorded the following net loss and net loss per share amounts:

	For the three months ended September 30, 2005	For the nine months ended September 30, 2005
Net loss:		
As reported	$ (2,288,000)	$ (12,174,000)
Add: Employee stock-based compensation expense included in reported net loss, net of related tax effects	341,000	341,000
Deduct: Total employee stock-based compensation expense determined under the fair value method for all awards, net of related tax effects	(551,000)	(1,968,000)
Pro forma	$ (2,498,000)	$ (13,801,000)
Basic and diluted loss per common share:		
As reported	$ (0.15)	$ (0.84)
Pro forma	$ (0.16)	$ (0.95)

Stock-Based Compensation Arrangements

During 2004, we adopted the 2004 Equity Incentive Plan (the “2004 Plan”), which provides our employees, directors and consultants the opportunity to purchase our common stock through non-qualified stock options, stock appreciation rights, restricted stock units, or restricted stock and cash awards. The 2004 Plan initially provides for issuance of 3,000,000 shares of our common stock, which number may be cumulatively increased (subject to Board discretion) on an annual basis beginning January 1, 2005, which annual increase shall not exceed 2% of our then outstanding stock.

During 1997, we adopted the 1997 Stock Option and Stock Purchase Plan (the “1997 Plan”), which provides for the direct award or sale of shares and for the grant of incentive stock options (“ISOs”) and non-statutory options to employees, directors or consultants. The 1997 Plan, as amended, provides for the issuance of up to 7,000,000 shares of our common stock. The exercise price of ISOs cannot be less than the fair market value of the underlying shares on the date of grant. ISOs can be granted only to employees.

Generally, awards issued under the 2004 Plan or the 1997 Plan are subject to four-year vesting, and have a contractual term of 10 years. Most awards contain one of the following two vesting provisions:

- 25% of a granted award will vest after one year of service, while an additional 1/48 of the award will vest at the end of each month thereafter for 36 months, or
- 1/48 of the award will vest at the end of each month over a four-year period.

A summary of activity for the options under the 1997 and 2004 Plans for the nine months ended September 30, 2006 is as follows:

	Options	Weighted Average Exercise Price
Balance as of January 1, 2006	5,784,741	$ 4.12
Granted	791,350	7.52
Exercised	(360,468)	2.27
Expired	(22,336)	7.10
Cancelled/forfeited	(310,441)	5.30
Balance as of September 30, 2006	5,882,846	$ 4.62

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	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value
Balance as of September 30, 2006	5,882,846	$ 4.62	5.7	$ 6,008,000
Vested and unvested expected to vest at September 30, 2006	5,786,693	$ 4.41	5.7	$ 5,889,000
Vested and exercisable at September 30, 2006	4,242,570	$ 4.23	4.5	$ 5,118,000

The total intrinsic value of stock options exercised was $1,837,000 and $483,000 for the nine months ended September 30, 2006 and 2005, respectively.

The fair value of each option awarded during the nine months ended September 30, 2006 was estimated on the date of grant using the Black-Scholes-Merton option valuation model based on the following assumptions:

Expected term	6 years
Risk-free interest rate	4.33-5.04%
Volatility	77.46-78.91%
Dividends	—
Resulting weighted average grant date fair value	$ 5.31

The expected term assumption was estimated using the “simplified method,” as described in Staff Accounting Bulletin No. 107, “Share-Based Payment” (“SAB 107”). This method estimates the expected term of an option based on the average of the vesting period and the contractual term of an option award.

The expected volatility assumption was based on the historical volatility of our common stock since the first day we became publicly traded (August 2000).

The weighted average risk-free interest rate represents the interest rate for treasury constant maturity instruments published by the Federal Reserve Board. If the term of available treasury constant maturity instruments is not equal to the expected term of an employee option, we use the weighted average of the two Federal Reserve securities closest to the expected term of the employee option.

The dividend yield has been assumed to be zero as we (a) have never declared or paid any dividends and (b) do not currently anticipate paying any cash dividends on our outstanding shares of common stock in the foreseeable future.

The following summarizes the total employee compensation cost recognized in the accompanying financial statements:

	For the nine months ended September 30, 2006	2005
Total compensation cost for share-based payment arrangements recognized in the statement of operations (net of tax of $0)	$2,635,000	$ —
Total compensation cost capitalized as part of the cost of an asset	$ —	$ —

As of September 30, 2006, the total compensation cost related to non-vested stock options not yet recognized for all of our plans is approximately $4,341,000. These costs are expected to be recognized over a weighted average period of 1.91 years.

In calculating the fair value of option awards granted after January 1, 2006, we generally used the same methodologies and assumptions employed prior to our adoption of SFAS 123R. For instance, our estimate of expected volatility is based exclusively on our historical volatility, since we have granted options that vest purely based on the passage of time and otherwise meet the criteria to exclusively rely on historical volatility, as set out in SAB 107. We did, however, change our policy of attributing the cost of share-based payment awards granted after January 1, 2006 from the “graded vesting approach” to the “straight-line” method. We believe that this change more accurately reflects the manner in which our employees vest in an option award.

In connection with convertible bridge financing in 1998 and 1999, we issued warrants to purchase 25,000 shares of our Series C convertible preferred stock. Upon conversion of our outstanding preferred stock in August 2000, the warrants became immediately exercisable into shares of our common stock. As of December 31, 2004, 2,777 of these warrants had been exercised. The remaining 22,223 warrants, with cash proceeds to the Company of approximately $50,000, were exercised in the third quarter of 2005.

Cash received from stock option and warrant exercises for the nine months ended September 30, 2006 and 2005 was approximately $819,000 and $207,000, respectively. No income tax benefits have been recorded related to the stock option exercises. SFAS 123R prohibits recognition of tax benefits for exercised stock options until such benefits are realized. As we presently have tax loss carryforwards from prior periods and expect to incur tax losses in 2006, we are not able to benefit from the deduction for exercised stock options in the current reporting period.

To settle stock option awards that have been exercised, we will issue new shares of our common stock. At September 30, 2006, we have an aggregate of 76,397,328 shares authorized and available to satisfy option exercises under our plans.

Cash used to settle equity instruments granted under share-based payment arrangements amounted to $0 in all periods presented.

Award Modification

In May 2006, our Senior Vice President of Finance and Administration, Treasurer, and Principal Accounting Officer terminated full-time employment with us. In connection with his full-time employment termination, we extended the exercise period of his 204,997 vested stock options as of May 31, 2006 to December 31, 2007. Moreover, we entered into a part-time employment agreement with him according to which all stock option vesting ceased as of May 31, 2006 and 75,003 non-vested stock options were cancelled on May 31, 2006.

In connection with a company-wide reduction in force, we eliminated the positions of our Senior Vice President, Business Development, and Vice President, Marketing & Development, on July 25, 2006. We subsequently entered into short-term employment agreements with the individuals formerly holding the titles of Senior Vice President, Business Development, and Vice President, Marketing and Development. These individuals continued to provide service to us following the elimination of their former positions on July 25, 2006. At the time these positions were eliminated, 142,686 non-vested stock options held by these two employees were forfeited. Moreover, subject to certain restrictions, we extended the exercise period for 328,564 vested stock options held by these employees to December 31, 2007.

We also eliminated the position of a less senior employee on July 31, 2006. Simultaneously, we continued the individual's employment in a new capacity; however, we cancelled 8,125 stock options as of July 31, 2006.

In connection with the above modifications and in accordance with SFAS 123R, we recorded additional expense of $279,000 and $567,000 for the three and nine months ended September 30, 2006, respectively, as components of research and development, general and administrative and sales and marketing expense. The $279,000 and $567,000 charges recorded in the third quarter and nine months ended September 30, 2006 constitute the entire expense related to these options, and no future period charges will be required.

Non-Employee Stock Based Compensation

In the first quarter of 2006, we granted 2,500 shares of restricted common stock to a non-employee scientific advisor. Because the shares granted are not subject to additional future vesting or service requirements, the stock based compensation expense of approximately $18,000 recorded in the first quarter of 2006 constitutes the entire expense related to this award, and no future period charges will be required. The stock is restricted only in that it cannot be sold for a specified period of time. There are no vesting requirements. This scientific advisor will also be receiving cash consideration as services are performed. The fair value of the stock granted was $7.04 per share based on the market price of our common stock on the date of grant. There were no discounts applied for the effects of the restriction, since the value of the restriction is considered to be de minimis. The entire charge of $18,000 was reported as a component of research and development expenses.

In the second quarter of 2005, we granted 20,000 shares of restricted common stock to a non-employee scientific advisor. Because the shares granted are not subject to additional future vesting or service requirements, the stock based compensation expense of approximately $63,000 recorded in the second quarter of 2005 as a component of research and devlopment expense constitutes the entire expense related to this grant, and no future period charges will be required. The fair value of the stock granted was $3.15 per share based on the market price of our common stock on the date of grant. The stock is restricted only in that it cannot be sold for a specified period of time. There are no vesting requirements. This scientific advisor will also be receiving cash consideration as services are performed.

6. Short-term Investments

We invest excess cash in highly liquid debt instruments of financial institutions and corporations with strong credit ratings and in United States government obligations. We have established guidelines relative to diversification and maturities that maintain safety and liquidity. These guidelines are periodically reviewed and modified to take advantage of trends in yields and interest rates.

We evaluate our investments in accordance with the provisions of SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities." Based on our intent, our investment policies and our ability to liquidate the debt securities, we classify short-term investment securities within current assets. Available-for-sale securities are carried at fair value, with unrealized gains and losses reported as accumulated other comprehensive income (loss) within stockholders' equity. The amortized cost basis of debt securities is periodically adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization is included as a component of interest income or interest expense. The amortized cost basis of securities sold is based on the specific identification method and all such realized gains and losses are recorded as a component within other income (expense). Based on such evaluation, management has determined that all investment securities (other than those classified as cash equivalents) are properly classified as available-for-sale.

We review the carrying values of our investments and write down such investments to estimated fair value by a charge to the statements of operations when the severity and duration of a decline in the value of an investment is considered to be other than temporary. The cost of securities sold or purchased is recorded on the settlement date.

At September 30, 2006, the excess of carrying cost over the fair value of our short-term investments is immaterial.

7. Inventories

Inventories include the cost of material, labor and overhead, and are stated at the lower of average cost, determined on the first-in, first-out (FIFO) method, or market. We periodically evaluate our on-hand stock and make appropriate provisions for any stock deemed as excess or obsolete.

We expense excess manufacturing costs- that is, costs resulting from lower than "normal" production levels. The provisions of SFAS No. 151, "Inventory Costs- an Amendment of ARB No. 43, Chapter 4," were adopted during the first quarter of 2006 and have not had a significant effect on our financial statements.

During the second quarter of 2006, we recorded a provision of $70,000 for excess raw materials that we determined were unlikely to be converted into finished goods and ultimately sold. There was no similar expense for the third quarter ended September 30, 2006.

During the third quarter of 2005, we recorded a provision of $132,000, primarily for excess HYDROSORB™ inventory. The inventory was produced in anticipation of stocking orders from Medtronic which did not materialize. We determined it was more likely than not that the inventory would not be recovered. A similar provision, for approximately $46,000, was recorded in the second quarter of 2005, for a total of $178,000 for the nine months ended September 30, 2005.

8. Long-Lived Assets

In accordance with SFAS No. 144, "Accounting for Impairment or Disposal of Long-Lived Assets," we assess certain of our long-lived assets, such as property and equipment and intangible assets other than goodwill, for potential impairment when there is a change in circumstances that indicates carrying values of assets may not be recoverable. Such long-lived assets are deemed to be impaired when the undiscounted cash flows expected to be generated by the asset (or asset group) are less than the asset's carrying amount. Any required impairment loss would be measured as the amount by which the asset's carrying value exceeds its fair value, and would be recorded as a reduction in the carrying value of the related asset and a charge to operating expense.

During the second quarter ended June 30, 2006, we recorded an additional $118,000 of depreciation expense to accelerate the estimated remaining lives for certain assets determined to be no longer in use. These assets related to furniture and fixtures no longer in use due to our recent relocation as well as outdated computer software and related equipment. The assets relate to both our regenerative cell technology and MacroPore Biosurgery operating segments. We recorded the charge as an increase to general and administrative expenses. There was no similar charge for the same period in 2005.

9. Revenue Recognition

Product Sales

We sell our (non-Thin Film) MacroPore Biosurgery products to Medtronic, Inc. ("Medtronic"), a related party, under a Distribution Agreement dated January 5, 2000 and amended December 22, 2000 and October 8, 2002, as well as a Development and Supply Agreement dated January 5, 2000 and amended December 22, 2000 and September 30, 2002. These revenues are classified as sales to related party in our statements of operations.

We recognize revenue on product sales to Medtronic only after both (a) the receipt of a purchase order from Medtronic and (b) shipment of ordered products to Medtronic, as title and risk of loss pass upon shipment.

On occasion, we will offer Medtronic extended payment terms. We do not recognize revenues under these arrangements until the payment becomes due or is received, if that occurs earlier. Moreover, we warrant that our products are free from manufacturing defects at the time of shipment. We have recorded a reserve for the estimated costs we may incur under our warranty program (see note 10).

License/Distribution Fees

If separable under Emerging Issues Task Force Issue 00-21, "Revenue Arrangements with Multiple Deliverables" ("EITF 00-21"), we recognize any upfront payments received from license/distribution agreements as revenues ratably over the period in which the customer benefits from the license/distribution agreement.

To date, we have not received any upfront license payments that are separable under EITF 00-21. Accordingly, such license revenues have been combined with other elements, such as research and development activities, for purposes of revenue recognition. For instance, we account for the license fees and milestone payments under the Distribution Agreement with Senko as a single unit of accounting. Similarly, we have attributed the upfront fees received under the arrangements with Olympus Corporation ("Olympus"), a related party (see note 17), to a combined unit of accounting comprising a license we granted to Olympus-Cytori, Inc. (the "Joint Venture"), a related party, as well as development services we agreed to perform for this entity.

On February 22, 2006, we granted Olympus an exclusive right to negotiate a commercialization collaboration for the use of adipose stem and regenerative cells for a specific therapeutic area outside of cardiovascular disease. In exchange for this right, we received $1,500,000 from Olympus, which is non-refundable but may be applied towards any definitive commercial collaboration in the future. As part of this agreement, Olympus will conduct market research and pilot clinical studies in collaboration with us over a 12 to 18 month period for the therapeutic area. The $1,500,000 payment was received in the second quarter of 2006 and recorded as deferred revenues, related party. The deferred revenues, related party will be recognized in the income statement either (i) in connection with other consideration received as part of a definitive commercial collaboration in the future, or (ii) when the exclusive negotiation period expires.

Research and Development

We earn revenue for performing tasks under research and development agreements with both commercial enterprises, such as Olympus and Senko, and governmental agencies like the National Institutes of Health ("NIH"). Revenue earned under development agreements is classified as either research grant or development revenues in our statements of operations, depending on the nature of the arrangement. The costs associated with earning these revenues are typically recorded as research and development expense.

We received a total of $22,000,000 from Olympus and Olympus-Cytori, Inc. during 2005 in two separate but related transactions (see note 17). Approximately $4,689,000 of this amount related to common stock that we issued, as well as two options we granted, to Olympus (see note 17 for further details). Moreover, during the first quarter of 2006, we received $11,000,000 from the Joint Venture upon achieving the CE Mark on the Celution™ System. Considering the $4,689,000 initially allocated to the common stock issued and the two options, we recorded upfront fees totaling $28,311,000 as deferred revenues, related party. In exchange for these proceeds, we agreed to (a) provide Olympus-Cytori, Inc. an exclusive and perpetual license to our therapeutic device technology, including the Celution™ System and certain related intellectual property, and (b) perform future development services related to commercializing the Celution™ System (see note 17). As noted above, the license and development services are not separable under EITF 00-21. Accordingly, we will recognize the $28,311,000 allocated to deferred revenues, related party, using a proportional performance methodology- that is, as we complete substantive milestones related to the development component of the combined accounting unit. As of September 30, 2006, we have recognized $683,000 of the deferred revenues, related party as development revenues. All related development costs are expensed as incurred and are included in research and development expense on the statement of operations.

In the third quarter of 2004, we entered into a Distribution Agreement with Senko. Under this agreement, we granted to Senko an exclusive license to sell and distribute certain Thin Film products in Japan. We have also earned or will be entitled to earn additional payments under the Distribution Agreement based on achieving the following defined research and development milestones:

- In 2004, we received a nonrefundable payment of $1,250,000 from Senko after filing an initial regulatory application with the Japanese Ministry of Health, Labour and Welfare ("MHLW") related to the Thin Film product line. We initially recorded this payment as deferred revenues of $1,250,000.

- Upon the achievement of commercialization (i.e., regulatory approval by the MHLW), we will be entitled to an additional nonrefundable payment of $250,000.

Of the amounts received and deferred, we recognized development revenues of $1,000 and $149,000 in the three and nine months ended September 30, 2006, respectively, representing the fair value of the completed milestones relative to the fair value of the total efforts expected to be necessary to achieve regulatory approval by the MHLW. In the three and nine months ended September 30, 2005, we recognized development revenue of $11,000 and $20,000, respectively. As noted above, the license and the milestone components of the Senko Distribution Agreement are accounted for as a single unit of accounting. This single element of $3,000,000 in fees includes a $1,500,000 license fee which is potentially refundable. We have recognized, and will continue to recognize, the non-contingent fees allocated to this combined deliverable as we complete performance obligations under the Distribution Agreement with Senko. We will not recognize the potentially refundable portion of the fees until the right of refund expires. See note 19 for further details.

Under our agreement with the NIH, we are reimbursed for "qualifying expenditures" related to research on adipose-derived cell therapy for myocardial infarction. To receive funds under the grant arrangement, we are required to (i) demonstrate that we incurred "qualifying expenses," as defined in the grant agreement between the NIH and us, (ii) maintain a system of controls, whereby we can accurately track and report all expenditures related solely to research on Adipose-Derived Cell Therapy for Myocardial Infarction, and (iii) file appropriate forms and follow appropriate protocols established by the NIH. When we are reimbursed for costs incurred under grant arrangements with the NIH, we recognize revenues for the lesser of:

- Qualifying costs incurred (and not previously recognized) to date, plus any allowable grant fees for which we are entitled to funding from the NIH; or,
- The outputs generated to date versus the total outputs expected to be achieved under the research arrangement.

In the three and nine months ended September 30, 2006, we recognized NIH grant revenue of $303,000 and $310,000 and incurred qualifying costs for the same amounts. For the three and nine months ended September 30, 2005, we recognized NIH grant revenue of $25,000 and $110,000, respectively, and incurred qualifying costs of $25,000 and $108,000 for the same periods.

10. Warranty

We provide a limited warranty under our agreements with our customers for products that fail to comply with product specifications. We have recorded a reserve for estimated costs we may incur under our warranty program.

The following summarizes the movements in our warranty reserve, which is subcategorized under accounts payable and accrued expenses, at September 30, 2006 and 2005:

	As of January 1,	Additions-charges to expenses	Claims	As of September 30,
2006:				
Warranty reserve	$ 155,000	$ 9,000	$ —	$ 164,000
2005:				
Warranty reserve	$ 102,000	$ 40,000	$ —	$ 142,000

11. Income Taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income (loss) in the years in which those temporary differences are expected to be recovered or settled. Due to our current loss position and expectations for the foreseeable future, a full valuation allowance was recognized against deferred tax assets.

12. Loss Per Share

We compute loss per share based on the provisions of SFAS No. 128, “Earnings Per Share.” Basic per share data is computed by dividing income or loss available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted per share data is computed by dividing net income or loss available to common stockholders by the weighted average number of common shares outstanding during the period increased to include, if dilutive, the number of additional common share equivalents that would have been outstanding if potential common shares had been issued using the treasury stock method. Potential common shares were related entirely to outstanding but unexercised option awards and warrants for all periods presented.

We have excluded all potentially dilutive securities from the calculation of diluted loss per share attributable to common stockholders for the three and nine months ended September 30, 2006 and 2005, as their inclusion would be antidilutive. Potentially dilutive common shares excluded from the calculations of diluted loss per share were 8,082,846 for the three and nine months ended September 30, 2006, and 7,547,076 for the three and nine months ended September 30, 2005.

13. Commitments and Contingencies

We have contractual obligations to make payments on leases of office and manufacturing space as follows:

Years Ending December 31,	Operating Leases
For the remainder of 2006	$ 520,000
2007	2,086,000
2008	1,556,000
2009	1,382,000
2010	707,000
Total	$ 6,251,000

On May 24, 2005, we entered into a lease for 91,000 square feet of space located at 3020 and 3030 Callan Road, San Diego, California. The majority of our operations are located in this facility. The agreement bears rent at an initial rate of $1.15 per square foot, with annual increases of 3%. The lease term is 57 months, commencing on October 1, 2005 and expiring on June 30, 2010. Payments for our Callan Road location commenced in June 2006.

Rent expense, which includes common area maintenance, for the three and nine months ended September 30, 2006 was $596,000 and $1,844,000, respectively. Rent expense for the same periods in 2005 was $492,000 and $996,000, respectively.

We are subject to various claims and contingencies related to legal proceedings. Due to their nature, such legal proceedings involve inherent uncertainties including, but not limited to, court rulings, negotiations between affected parties and governmental actions. Management assesses the probability of loss for such contingencies and accrues a liability and/or discloses the relevant circumstances, as appropriate. Management believes that any liability to us that may arise as a result of currently pending legal proceedings will not have a material adverse effect on our financial condition, liquidity, or results of operations as a whole.

Refer to note 14 for a discussion of our commitments and contingencies related to our interactions with the University of California.

Refer to note 17 for a discussion of our commitments and contingencies related to our transactions with Olympus, including (a) our obligation to the Joint Venture in future periods and (b) certain put and call rights embedded in the arrangements with Olympus.

Refer to note 18 for a discussion of our commitments and contingencies related to our arrangements with MAST and Senko.

14. License Agreement

On October 16, 2001, StemSource, Inc. entered into an exclusive worldwide license agreement with the Regents of the University of California (“UC”), licensing all of UC’s rights to certain pending patent applications being prosecuted by UC and (in part) by the University of Pittsburgh (“U Pitt”), for the life of these patents, with the right of sublicense. The exclusive license relates to an issued patent (“Patent 6,777,231”) and various pending applications relating to adipose derived stem cells. In November 2002, we acquired StemSource, and the license agreement was assigned to us.

The agreement, which was amended and restated in September 2006 to better reflect our business model, calls for various periodic payments until such time as we begin commercial sales of any products utilizing the licensed technology. Upon achieving commercial sales of products or services covered by the UC license Agreement, we will be required to pay variable earned royalties based on the net sales of products sold. Minimum royalty amounts will increase annually with a plateau in the fourth year.

In connection with the amendment of the agreement in the third quarter of 2006, we agreed to issue 100,000 shares of our common stock to UC in the fourth quarter of 2006. At the time the agreement was reached, our shares were trading at $4.87 per share. Accordingly, we accrued $487,000 in the third quarter of 2006 and recognized a corresponding general and administrative expense.

Additionally, we are obligated to reimburse UC for patent prosecution and other legal costs on any patent applications contemplated by the agreements. In particular, the University of Pittsburgh filed a lawsuit in the fourth quarter of 2004, naming all of the inventors who had not assigned their ownership interest in Patent 6,777,231 to U Pitt. It was seeking a determination that its assignors, rather than UC's assignors, are the true inventors of Patent 6,777,231. This lawsuit has subjected us to and
could continue to subject us to significant costs and, if U Pitt wins the lawsuit, our license rights to this patent could be nullified or rendered non-exclusive with respect to any third party that might license rights from U Pitt. Accordingly, it could have a negative effect on us if U Pitt were to win the lawsuit.

We are not named as a party to the lawsuit but our president, Marc Hedrick, is one of the inventors identified on the patent and therefore is a named individual defendant. We are providing substantial financial and other assistance to the defense of the lawsuit.

In the three and nine months ended September 30, 2006, we expensed $335,000 and $1,701,000, respectively, related to this license. For the same periods in 2005, we expensed $349,000 and $923,000, respectively. These expenses have been classified as general and administrative expense in the accompanying consolidated financial statements. We believe that the amount accrued as of September 30, 2006 is a reasonable estimate of our liability for the expenses incurred to date. We paid UC $240,000 against the related accrual on June 30, 2006.

15. Long-term Obligations

In 2003, we entered into an Amended Master Security Agreement to provide financing for new equipment purchases.

As of September 30, 2006, the future contractual principal payments, for the remainder of 2006 and subsequent years, on all of our outstanding promissory notes related to the Amended Master Security Agreement are as follows:

Years Ending December 31,	
Remainder of 2006	$ 238,000
2007	836,000
2008	544,000
2009	178,000
Total	$1,796,000

16. Composition of Certain Financial Statement Captions

Inventories, net

As of September 30, 2006 and December 31, 2005, inventories, net, were comprised of the following:

	September 30, 2006	December 31, 2005
Raw materials	$ 150,000	$ 232,000
Finished goods	60,000	26,000
	$ 210,000	$ 258,000

Other Current Assets

As of September 30, 2006 and December 31, 2005, other current assets were comprised of the following:

	September 30, 2006	December 31, 2005
Prepaid expenses	$ 723,000	$ 506,000
Accrued interest receivable	43,000	77,000
Other receivables	15,000	38,000
	$ 781,000	$ 621,000

Property and Equipment, net

As of September 30, 2006 and December 31, 2005, property and equipment, net, were comprised of the following:

	September 30, 2006	December 31, 2005
Manufacturing and development equipment	$ 2,930,000	$ 2,676,000
Office and computer equipment	2,613,000	2,682,000
Leasehold improvements	5,031,000	3,359,000
	10,574,000	8,717,000
Less accumulated depreciation and amortization	(5,996,000)	(5,132,000)
	$ 4,578,000	$ 3,585,000

Accounts Payable and Accrued Expenses

As of September 30, 2006 and December 31, 2005, accounts payable and accrued expenses were comprised of the following:

	September 30, 2006	December 31, 2005
Accrued legal fees	$ 1,597,000	$ 975,000
Accrued vacation	607,000	680,000
Accrued bonus	522,000	981,000
Stock to be issued for license amendment, related party (note 14)	487,000	—
Accrued expenses	452,000	504,000
Accounts payable	359,000	933,000
Accrued studies	281,000	712,000
Deferred rent expense	253,000	138,000
Warranty reserve (note 10)	164,000	155,000
Accrued accounting fees	103,000	199,000
Accrued payroll	25,000	52,000
Accrued leasehold improvements	—	800,000
	$ 4,850,000	$ 6,129,000

17. Transactions with Olympus Corporation

Initial Investment by Olympus Corporation in Cytori

In the second quarter of 2005, we entered into a Common Stock Purchase Agreement (the “Purchase Agreement”) with Olympus in which we received $11,000,000 in cash proceeds.

Under this agreement, we issued 1,100,000 newly issued shares of common stock to Olympus. We reflected the common stock issued to Olympus in our financial statements at the market value of our common stock at the time of the Purchase Agreement ($2.73 per share, or $3,003,000 in the aggregate).

In addition, we also granted Olympus an immediately exercisable option to acquire 2,200,000 shares of our common stock on or before December 31, 2006 at $10 per share. We have accounted for this grant as a liability in accordance with EITF 00-19, “Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock” because from the date of grant through the expiration, we are required to deliver listed common stock to settle the option shares upon exercise.

At the time we entered into the Purchase Agreement, we estimated the fair value of the option liability to be $186,000 based on the following assumptions:

- Contractual term of 1.67 years,
- Risk-free interest rate of 3.46%, and
- Estimated share-price volatility of 59.7%

As of September 30, 2006 and December 31, 2005, we re-estimated the fair value of the option liability to be $17,000 and $3,714,000, respectively, based on the following assumptions:

- Contractual term of 3 months and 1 year,
- Risk-free interest rate of 4.89% and 4.38%, and
- Estimated share-price volatility of 61.8% and 65.1%, respectively.

The decrease in the fair value by $574,000 and $3,714,000 for the three and nine months ended September 30, 2006 was recorded in the statements of operations as a component of change in fair value of option liabilities. This decrease was mainly attributable to the decline in our share price from December 31, 2005 to September 30, 2006 and to the reduction in the remaining term due to normal lapse of time. The option expires on December 31, 2006.

The $11,000,000 in total proceeds we received in the second quarter of 2005 exceeded the sum of (i) the market value of our stock as well as (ii) the fair value of the option at the time we entered into the share purchase agreement. The $7,811,000 difference between the proceeds received and the fair values of our common stock and option liability is recorded as a component of deferred revenues, related party in the accompanying balance sheet.

In August 2006, we received an additional $11,000,000 from Olympus for the issuance of approximately 1,900,000 shares of our common stock at $5.75 per share from the shelf registration filed in May, 2006. The purchase price was determined by our closing price on August 9, 2006.

As of September 30, 2006, Olympus holds approximately 16.20% of our issued and outstanding shares. If Olympus had decided to exercise its option on September 30, 2006 to purchase all 2,200,000 shares, it would have held 25.06% of our outstanding common stock as of September 30, 2006. Additionally, Olympus has a right, which it has not yet exercised, to designate a director to serve on our Board of Directors.

Formation of the Olympus-Cytori Joint Venture

On November 4, 2005, we entered into a joint venture and other related agreements (the “Joint Venture Agreements”) with Olympus. The Joint Venture is owned equally by Olympus and us.

Under the Joint Venture Agreements:

- Olympus paid $30,000,000 for its 50% interest in the Joint Venture. Moreover, Olympus simultaneously entered into a License/Joint Development Agreement with the Joint Venture and us to develop a second generation commercial system and manufacturing capabilities.
- We licensed our device technology, including the Celution™ System and certain related intellectual property, to the Joint Venture for use in future generation devices. These devices will process and purify adult stem and regenerative cells residing in adipose (fat) tissue for various therapeutic clinical applications. In exchange for this license, we received a 50% interest in the Joint Venture, as well as an initial $11,000,000 payment from the Joint Venture; the source of this payment was the $30,000,000 contributed to the Joint Venture by Olympus. Moreover, upon receipt of a CE mark for the first generation Celution™ System in January 2006, we received an additional $11,000,000 development milestone payment from the Joint Venture.

As a result of the $30,000,000 cash contribution to the Joint Venture by Olympus, we realized an immediate appreciation in the carrying value of our interests in the Joint Venture. As a result, we reported accretion of interests in the Joint Venture of $3,829,000 as a credit directly to additional paid-in capital in the fourth quarter of 2005. This accounting treatment is required by Securities and Exchange Commission Staff Accounting Bulletin No. 51, “Accounting for Sales of Stock by a Subsidiary,” which prohibits gains from equity transactions (in this case, the non-cash accretion of the interests held in an investment issuing additional shares to another shareholder) when such entity is a “newly-formed, non-operating entity” or a “research and development stage company.”

We have determined that the Joint Venture is a variable interest entity (“VIE”) pursuant to FASB Interpretation No. 46 (revised 2003), “Consolidation of Variable Interest Entities - An Interpretation of ARB No. 51” (“FIN 46R”), but that Cytori is not the VIE’s primary beneficiary. Accordingly, we have accounted for our interests in the Joint Venture using the equity method of accounting, since we can exert significant influence over the Joint Venture’s operations. At September 30, 2006, the carrying value of our investment in the Joint Venture is $82,000.

We are under no obligation to provide additional funding to the Joint Venture, but may choose to do so. In the first quarter of 2006, we contributed $150,000 to the Joint Venture.

Put/Calls and Guarantees

The Shareholders’ Agreement between Cytori and Olympus provides that in certain specified circumstances of insolvency or if we experience a change in control, Olympus will have the rights to (i) repurchase our interests in the Joint Venture at the fair value of such interests or (ii) sell its own interests in the Joint Venture to Cytori at the higher of (a) $22,000,000 or (b) the Put's fair value.

As of November 4, 2005, the fair value of the Put was determined to be $1,500,000. At December 31, 2005, the fair value of the Put was $1,600,000, and increased to $1,800,000 for the quarter ended September 30, 2006. The change of $200,000 was recorded in the statements of operations as a component of Change in fair value of option liabilities. The Put value itself, which is perpetual, has been recorded in the caption Long-term option liabilities in the balance sheet.

The valuations of the Put were completed by an independent valuation firm using an option pricing theory based simulation analysis (i.e., a Monte Carlo simulation). The valuations are based on assumptions as of the valuation date with regard to the market value of Cytori and the estimated fair value of the Joint Venture, the expected correlation between the values of Cytori and the Joint Venture, the expected volatility of Cytori and the Joint Venture, the bankruptcy recovery rate for Cytori, the bankruptcy threshold for Cytori, the probability of a change of control event for Cytori, and the risk free rate.

The following assumptions were employed in estimating the value of the Put at September 30, 2006 (these assumptions were not materially different from those used in valuing the Put as of November 4, 2005, and December 31, 2005):

- The expected volatilities of Cytori and the Joint Venture were assumed to be 63.2% and 69.1%, respectively,
- The bankruptcy recovery rate for Cytori was assumed to be 21%,
- The bankruptcy threshold for Cytori was assumed to be $10.78 million,
- The probability of a change of control event for Cytori was assumed to be 3.04%,
- The expected correlation between fair values of Cytori and the Joint Venture in the future was assumed to be 99%, and
- The risk free rate was assumed to be 4.64%.

The Put has no expiration date. Accordingly, we will continue to recognize a liability for the Put and mark it to market each quarter until it is exercised or until the arrangements with Olympus are amended.

The Joint Venture has exclusive access to our technology for the development, manufacture, and supply of the devices (second generation and beyond) for all therapeutic applications. Once a second generation Celution™ System is developed and approved by regulatory agencies, the Joint Venture may sell such systems exclusively to us at a formula-based transfer price; we have retained marketing rights to the second generation devices for all therapeutic applications of adipose stem and regenerative cells.

As part of the various agreements with Olympus, we will be required, following commercialization of the Celution™ System, to provide monthly forecasts to the Joint Venture specifying the quantities of each category of devices that we intend to purchase over a rolling six-month period. Although we are not subject to any minimum purchase requirements, we are obliged to buy a minimum percentage of the products forecasted by us in such reports. Since we can effectively control the number of devices we will agree to purchase and because no commercial devices have yet been developed to trigger the forecast requirement, we estimate that the fair value of this guarantee is de minimis as of September 30, 2006.

Deferred revenues, related party

As of September 30, 2006, the deferred revenues, related party account primarily consists of the consideration we have received in exchange for future services that we have agreed to perform on behalf of Olympus and the Joint Venture. These services include completing preclinical and clinical studies, product development and seeking regulatory approval for the treatment of various therapeutic conditions with adult stem and regenerative cells residing in adipose (fat) tissue. These services also include providing an exclusive and perpetual license to our device technology, including the Celution™ System and certain related intellectual property.

Pursuant to EITF 00-21, we have concluded that the license and development services must be accounted for as a single unit of accounting. Refer to note 9 for a full description of our revenue recognition policy.

18. Gain on Sale of Assets, Thin Film Product Line

In May 2004, we sold most, but not all, of our intellectual property rights and tangible assets related to our Thin Film product line to MAST (see note 19). The carrying value of the assets transferred to MAST prior to disposition totaled $634,000, and was comprised of the following:

- Finished goods inventory of $177,000,
- Manufacturing and development equipment of $217,000, and
- Goodwill of $240,000.

Under this agreement we were contractually entitled to the following additional consideration (none of this consideration has been recognized in the financial statements):

- $200,000, payable only upon receipt of 510(k) clearance from the U.S. Food and Drug Administration (“FDA”) for a hernia wrap product (thin film combined product); and

- $2,000,000 on or before the earlier of (i) May 31, 2005, known as the “Settlement Date,” or (ii) 15 days after the date upon which MAST has hired a Chief Executive Officer (“CEO”), provided the CEO held that position for at least four months and met other requirements specified in the sale agreement. Note that clause (ii) effectively means that we would not have received payment of $2,000,000 before May 31, 2005 unless MAST had hired a CEO on or before January 31, 2005 (four months prior to the Settlement Date). Moreover, in the event that MAST had not hired a CEO on or before January 31, 2005, MAST may have (at its sole option and subject to the requirements of the sale agreement) alternatively provided us with a 19% equity interest in the MAST business that is managing the Thin Film assets at May 31, 2005 in lieu of making the $2,000,000 payment. Our contention was that MAST did in fact hire a CEO on or before January 31, 2005, and thus, we were entitled to a $2,000,000 cash payment on or before May 31, 2005.

MAST did not make the payments specified above. Therefore, on June 14, 2005, we initiated arbitration proceedings against MAST, asserting that MAST was in breach of the Asset Purchase Agreement by failing to pay the final $2,000,000 in purchase price (among other issues). MAST responded asserting its own claims on or about June 23, 2005. MAST’s claims included but were not limited to the following allegations: (i) we inadequately transferred know-how to MAST, (ii) we misrepresented the state of the distribution network, (iii) we provided inadequate product instructions to users, and (iv) we failed to adequately train various distributors.

In August 2005, the parties settled the arbitration proceedings and gave mutual releases of all claims, excepting those related to the territory of Japan, and agreed to contractual compromises, the most significant of which is our waiving of the obligation for MAST to either pay the final cash purchase installment of $2,000,000 or to deliver 19% of its shares. Moreover, if MAST exercises its Purchase Right (see note 18) and Thin Film products are marketed in Japan, MAST would no longer be obliged to share certain gross profits and royalties with us.

In exchange, MAST agreed to supply - at no cost to us - all required product for any necessary clinical study for the territory of Japan and to cooperate in the planning of such study. However, if MAST exercises its Purchase Right or if we enter into a supply agreement with MAST for the territory of Japan, we would be obliged to reimburse MAST for any Thin Film product supplied in connection with the Japanese study at a cost of $50 per sheet.

As a result of the arbitration settlement, we recognized the remaining deferred gain on sale of assets of $5,650,000, less $124,000 of related deferred costs, in the statement of operations in the third quarter of 2005.

19. Thin Film Japan Distribution Agreement

In the third quarter of 2004, we entered into a Distribution Agreement with Senko. Under this agreement, we granted to Senko an exclusive license to sell and distribute certain Thin Film products in Japan. Specifically, the license covers Thin Film products with the following indications:

- Anti-adhesion,

- Soft tissue support, and

- Minimization of the attachment of soft tissues throughout the body.

The Distribution Agreement with Senko commences upon “commercialization.” In simplest terms, commercialization occurs when one or more Thin Film product registrations are completed with the MHLW.

Following commercialization, the Distribution Agreement has a duration of five years and is renewable for an additional five years after reaching mutually agreed minimum purchase guarantees.

The Distribution Agreement also provides for us to supply certain products to Senko at fixed prices over the life of the agreement once we have received approval to market these products in Japan. In addition to the product price, Senko will also be obligated to make royalty payments to us of 5% of the sales value of any products Senko sells to its customers during the first three years post-commercialization.

At the inception of this arrangement, we received a $1,500,000 license fee which was recorded as deferred revenues in 2004. We have also received $1,250,000 in milestone payments from Senko. See “Revenue Recognition” under note 9 above for our policies with regard to the timing of when these amounts will be recognized as revenues.

As part of the Thin Film sales agreement (see note 18), we granted MAST a right to acquire our Thin Film-related interest in Japan (the “Purchase Right”) during the time period and according to the following terms:

- From May 31, 2005 to May 31, 2007, the exercise price of the Purchase Right will be equal to the fair market value of the Japanese business, but in no event will be less than $3,000,000.

- Moreover, between May 31, 2005 and May 31, 2007, MAST will have a right of first refusal to match the terms of any outside offer to buy our Japanese Thin Film business.

We have agreed to provide back-up supply of products to Senko subject to the terms of the Distribution Agreement in the event that (a) MAST exercises its Purchase Right and (b) MAST materially fails to deliver product to Senko. In this circumstance, Senko would pay any amounts due for purchases of product, as well as make royalty payments directly to us. We would be obliged to remit 5% of the gross margin to MAST on any products sold to Senko. We believe that it is unlikely in practice that this contingency will materialize. Accordingly, we estimate the fair value of this guarantee to be de minimis as of the end of the current reporting period.

20. Equity Offering

In May 2006, we filed a shelf registration statement to allow ourselves the ability to raise capital through the issuance of common stock, preferred stock, or warrants. In the third quarter of 2006 we received approximately $16,800,000 from the sale of 2,918,255 shares of common stock at $5.75 per share. The purchase price was determined by our closing price on August 9, 2006. Of the amount issued, Olympus purchased $11,000,000 while the balance was purchased by certain institutional investors.

We incurred approximately $428,000 in costs related to this issuance, which was included in the net increase of approximately $16,400,000 to our additional paid-in-capital.

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

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This report contains certain statements that may be deemed "forward-looking statements" within the meaning of United States securities laws. All statements, other than statements of historical fact, that address activities, events or developments that we intend, expect, project, believe or anticipate will or may occur in the future are forward-looking statements. Such statements are based upon certain assumptions and assessments made by our management in light of their experience and their perception of historical trends, current conditions, expected future developments and other factors they believe to be appropriate. The forward-looking statements included in this report are also subject to a number of material risks and uncertainties, including but not limited to the risks described under the "Risk Factors" section in Part II below.

We encourage you to read those descriptions carefully. We caution you not to place undue reliance on the forward-looking statements contained in this report. These statements, like all statements in this report, speak only as of the date of this report (unless an earlier date is indicated) and we undertake no obligation to update or revise the statements except as required by law. Such forward-looking statements are not guarantees of future performance and actual results will likely differ, perhaps materially, from those suggested by such forward-looking statements.

Overview

Cytori Therapeutics, Inc. is developing treatments derived from stem cells that reside naturally in adipose (fat) tissue. We are focused on developing applications for these cells for acute myocardial infarction (heart attack), chronic ischemia, a severe form of coronary artery disease, and for use in reconstructive surgery. Our goal is to advance these applications into and through clinical trials and commercialize these therapies with an innovative cell processing device called the Celution™ System. This system automates the complex procedure for extracting and concentrating a patient's stem and regenerative cells from his/her own adipose tissue at the bedside in about an hour.

The research and development of our adipose stem and regenerative cell therapies has been, and will continue to be, very costly in order to fund clinical trials, preclinical development, and basic research. Research and development expenses for the nine months ended September 2006 increased substantially compared to the same period in 2005 primarily due to the increase in research and clinical development staff.

To address our funding requirements and bolster our cash reserves, in August 2006 we raised approximately $16,800,000 from the sale of 2,918,255 shares of common stock at $5.75 per share. Of the amount of stock sold, Olympus Corporation ("Olympus") purchased $11,000,000 while the balance was purchased by new and existing institutional investors. Olympus continues to hold an option to purchase up to 2,200,000 shares of Cytori's common stock, which expires on December 31, 2006.

Our Board of Directors has decided to divest and is actively seeking a buyer (or buyers) for our remaining MacroPore Biosurgery assets as a means to further bolster our cash position as well as to eliminate expenses related to maintaining product manufacturing operations. Revenues from our MacroPore Biosurgery business have dropped significantly, resulting in negative gross margins in the second and third quarters of 2006, which has reduced our cash position and contributed to our increased net losses.

During the third quarter, we reduced our staff by approximately 18% predominantly due to our decreased emphasis on the MacroPore Biosurgery business line. This will further streamline our operations by significantly decreasing our operating expenses. It also reflects the increased focus on our regenerative cell technology and clinical development.

Our increased research and development efforts in the regenerative cell segment year-to-date resulted in the achievement of many milestones. During this time, we received regulatory clearance on the clinical trial version of our Celution™ System in Europe (CE Mark). With this approval and based on our preclinical data, we expect to initiate clinical studies in Europe to seek reimbursement and claims expansion so that we may market the device for specific therapeutic applications. A safety and feasibility study is scheduled to begin before the end of 2006 to study the use of adipose stem regenerative cells processed via the Celution™ System as a treatment for chronic ischemia, a severe form of coronary artery disease. A second safety and feasibility study is being designed to study the use of these cells for acute myocardial infarction, which we anticipate will begin in 2007.

During the third quarter, we reported data on an important preclinical porcine study evaluating the use of adipose stem and regenerative cells processed via the Celution™ System for treating chronic ischemia. The findings were that injection of adipose stem and regenerative cells into ischemic areas of a heart imparted a statistically significant improvement in ejection fraction, a measure of the heart's pumping efficiency, and ventricular wall thickness, which may slow the deterioration of its pumping ability. We believe the mechanism by which this benefit was imparted is through angiogenesis, which promotes blood vessel growth and increases perfusion in and around the ischemic area.

During the second and third quarters of 2006, the first 11patients were treated in an investigator-initiated study in Japan utilizing our Celution™ System to explore the use of adipose stem and regenerative cells in breast reconstruction following a partial mastectomy. This application could serve as an alternative to a synthetic implant or a complicated surgical procedure. Based on the investigator's preliminary observations, he feels there is a high likelihood that the primary evaluation endpoints of safety and feasibility were met and therefore no further patient enrollment is required. We are evaluating the sponsorship of larger studies for the same application in Japan and Europe to support market adoption in these regions.

Transactions with Olympus

During 2005 and 2006, we entered into a number of strategic and collaboration arrangements with Olympus. In the second quarter of 2005, Olympus purchased 1,100,000 shares of our common stock. In addition, we granted Olympus an option to purchase up to 2,200,000 additional shares of common stock at $10.00 per share; this option expires December 31, 2006. Olympus was also given a right to nominate one of our Directors, but has not yet exercised this right. We received $11,000,000 from Olympus upon signing this agreement.

On November 4, 2005, we formed a joint venture with Olympus called Olympus-Cytori, Inc. (the "Joint Venture"). We received $11,000,000 in cash from the Joint Venture, the source of which was from Olympus' initial investment in the entity.

The Joint Venture plans to develop and manufacture future generation devices (based on our existing Celution™ System) that will process and purify adult stem and regenerative cells residing in adipose tissue, also known as fat. The Joint Venture alliance creates synergies between two companies that share the same vision for regenerative medicine. Olympus, as a worldwide leader in the development of innovative medical products, will contribute its expertise in engineering, manufacturing and servicing of sophisticated devices. In parallel, we will increase our focus on the development of therapeutic applications for adipose stem and regenerative cells for multiple large markets. Together, this alignment enables the creation of a premier brand of devices for regenerative medicine, to be sold by us.

As a result of the various arrangements with Olympus, we received $22,000,000 in cash during 2005. We also received an additional $11,000,000 milestone payment in January 2006 after obtaining a CE Mark for the first generation Celution™ System. In the third quarter of 2006, we issued to Olympus an additional 1,913,043 shares for an aggregate amount of $11,000,000, which we received in August 2006. We may possibly receive even more cash proceeds if Olympus decides to exercise its option to purchase 2,200,000 shares of Cytori common stock. If Olympus had chosen to exercise its option on September 30, 2006 to purchase all 2,200,000 shares, it would have held 25.06% of our outstanding common stock as of September 30, 2006.

We have been using and plan to continue to use the $44,000,000 in total cash proceeds received from Olympus to fund the development activities that are necessary to support the commercialization of future generation devices based on our Celution™ System. These development activities include performing preclinical and clinical trials, seeking regulatory approval, and performing product development related to therapeutic applications for adipose stem and regenerative cells for multiple large markets.

In connection with the joint venture arrangement with Olympus, Cytori is provided with a source of revenue in the near-and-medium-term. Initially, we recorded $28,311,000 as deferred revenues, related party, a liability account, in the consolidated balance sheet.

This balance sheet account represents unearned payments for future services that we have agreed to perform on behalf of the Joint Venture. As we complete our future service obligations, we will recognize income (using a proportional performance methodology) and reduce the deferred revenues, related party account. Specifically, we have recognized a portion of the $28,311,000 as revenue and will continue to do so through 2009. The exact timing of when amounts will be reported as development revenue will depend on internal factors (for instance, our ability to complete the service obligations we have agreed to perform) as well as external considerations, including obtaining the necessary regulatory approvals for various therapeutic applications related to the Celution™ System.

As part of the various agreements with Olympus, we will be required, following commercialization of the Celution™ System, to provide monthly forecasts to the Joint Venture specifying the quantities of each category of devices that we intend to purchase over a rolling six-month period. Although we are not subject to any minimum purchase requirements, we are obliged to buy a minimum percentage of the products forecasted by us in such reports. Since we can effectively control the number of devices we will agree to purchase and because no commercial devices have yet been developed to trigger the forecast requirement, we estimate that the fair value of this guarantee is de minimis as of September 30, 2006 and therefore no amounts related to this guarantee are reflected on the balance sheet.

In certain specified circumstances of insolvency or if we experience a change in control, Olympus will have the rights to (i) repurchase our interests in the Joint Venture at the fair value of such interests or (ii) sell its own interests in the Joint Venture to us at the higher of (a) $22,000,000 or (b) the Put's fair value. These put and call rights are contingent on events that are unlikely to occur. Nonetheless, accepted valuation techniques suggest that the put right has a value of approximately $1,800,000 as of September 30, 2006. This value has been recorded as a component of Option liabilities in our balance sheet. Note that the put right is perpetual. Accordingly, we will continue to recognize a liability for the Put and mark it to market each quarter until it is exercised or until the arrangements with Olympus are amended.

We determined that the Joint Venture is a variable interest entity (“VIE”) under FASB Interpretation No. 46 (revised 2003), “Consolidation of Variable Interest Entities - An Interpretation of ARB No. 51” (“FIN 46R”), but that we are not the Joint Venture’s primary beneficiary. Accordingly, we have accounted for our interests in the Joint Venture using the equity method of accounting, since we can exert significant influence over the Joint Venture’s operations.

In February 2006, we granted Olympus an exclusive right to negotiate a commercialization collaboration for the use of adipose stem and regenerative cells for a specific therapeutic area outside of cardiovascular disease. In exchange for this right, we received $1,500,000 from Olympus, which is non-refundable but may be applied towards any definitive commercial collaboration in this therapeutic area in the future. As part of this agreement, Olympus will conduct market research and pilot clinical studies in collaboration with us over a 12 to 18 month period for the therapeutic area. The $1,500,000 represents a portion of the deferred revenues, related party account in the balance sheet and will be recognized in the income statement either (i) in connection with other consideration received as part of a definitive commercial collaboration in the future, or (ii) when the exclusive negotiation period expires.

Thin Film Japan Distribution Agreement

Even after consummation of the 2004 Thin Film asset sale to MAST, we retained all rights to Thin Film business in Japan (subject to a purchase option of MAST, as described later below), and we received back from MAST a license of all rights to Thin Film technologies in the:

- Spinal field, exclusive at least until 2012, and
- Field of regenerative medicine, non-exclusive on a perpetual basis.

In the third quarter of 2004, we entered into a Distribution Agreement with Senko. Under this agreement, we granted to Senko an exclusive license to sell and distribute certain Thin Film products in Japan. Specifically, the license covers Thin Film products with the following indications:

- Anti-adhesion,
- Soft tissue support, and
- Minimization of the attachment of soft tissues throughout the body.

The Distribution Agreement with Senko commences upon "commercialization." In simplest terms, commercialization occurs when one or more Thin Film product registrations are completed with the Japanese Ministry of Health, Labour and Welfare ("MHLW").

Following commercialization, the Distribution Agreement has a duration of five years and is renewable for an additional five years after reaching mutually agreed minimum purchase guarantees.

We received a $1,500,000 upfront license fee from Senko. We have recorded the $1,500,000 received as a component of deferred revenues in the accompanying balance sheet. Half of the license fee is refundable if the parties agree commercialization is not achievable and a proportional amount is refundable if we terminate the arrangement, other than for material breach by Senko, before three years post-commercialization.

Under the Distribution Agreement, we will also be entitled to earn additional payments from Senko based on achieving defined milestones. On September 28, 2004, we notified Senko of completion of the initial regulatory application to the MHLW for the Thin Film product. As a result, we became entitled to a nonrefundable payment of $1,250,000, which we received in October 2004 and recorded as a component of deferred revenues. To date we have recognized a total of $358,000 in development revenues ($149,000 and $20,000 for the nine months ended September 30, 2006 and 2005, respectively).

The previously mentioned 2004 sale agreement granted MAST a "Purchase Right" to acquire, at any time before May 31, 2007, our Thin Film-related interests and rights for Japan. If MAST chooses to exercise the Purchase Right between now and May 31, 2007, the exercise price of the Purchase Right will be equal to the fair market value of the Japanese business, but in no event will be less than $3,000,000. Moreover, until May 31, 2007, MAST has a right of first refusal to match the terms of any outside offer to buy our Japanese Thin Film business.

Stock-Based Compensation

In January 2006, we adopted Financial Accounting Standards Board Statement No. 123R, Share-Based Payment ("SFAS 123R"). SFAS 123R requires us to measure all share-based payment awards granted after, or that were unvested as of, January 1, 2006 at fair value.

We have recognized non-employee stock-based compensation expense of $18,000 and $63,000 for the nine months ended September 30, 2006 and 2005, respectively. We adopted SFAS 123R using the modified prospective method of transition. Employee stock-based compensation expense of $2,635,000 was recorded for the nine months ended September 30, 2006, and $337,000 was reported in the nine months ended September 30, 2005. Specifically, we recorded compensation expense for:

- Awards granted after January 1, 2006, and
- The unvested portion of previously granted awards outstanding at the date of adoption.

Awards granted to employees prior to our implementation of SFAS 123R were accounted for under the recognition and measurement principles of APB Opinion No. 25, "Accounting for Stock Issued to Employees," and related Interpretations.

As of September 30, 2006, the total compensation cost related to non-vested stock options not yet recognized for all plans presented is approximately $4,341,000. These costs are expected to be recognized over a weighted average period of 1.91 years.

In calculating the fair value of option awards granted after January 1, 2006, we, for the most part, used the same methodologies and assumptions employed prior to our adoption of SFAS 123R. For instance, our estimate of expected volatility is based exclusively on our historical volatility, since we have granted options that vest purely based on the passage of time and otherwise meet the criteria to exclusively rely on historical volatility, as set out in Staff Accounting Bulletin No. 107, "Share-Based Payment". We did, however, change our policy of attributing the cost of share-based payment awards granted after January 1, 2006 from the "graded vesting approach" to the "straight-line" method. We believe that this change more accurately reflects the manner in which our employees vest in an option award.

Since the adoption of SFAS 123R, we have not made any changes to the types of awards we have historically granted to our employees. However, upon termination of our Senior Vice President of Finance and Administration, Treasurer, and Principal Accounting Officer in May 2006, we extended his post-separation exercise period on his vested stock options until December 31, 2007. Furthermore, upon elimination of the positions of our Senior Vice President, Business Development, and Vice President, Marketing & Development, in July 2006, we granted both employees an extension of the exercise period on their vested stock options until December 31, 2007. These modifications were based on a business decision related to the awards of three specific individuals and is not in any way related to the implementation of SFAS 123R.

Results of Operations

Product revenues

Product revenues relate to our MacroPore Biosurgery segment and include revenues from our spine and orthopedic products. The following table summarizes the components for the three and nine months ended September 30, 2006 and 2005:

	For the three months ended September 30,				For the nine months ended September 30,			
	2006	2005	$ Differences	% Differences	2006	2005	$ Differences	% Differences
Spine and orthopedics products	$ 133,000	$ 1,544,000	$ (1,411,000)	(91.4)%	$ 1,087,000	$ 4,776,000	$ (3,689,000)	(77.2)%
% attributable to Medtronic	100%	100%			100%	100%		

Spine and orthopedic product revenues represent sales of bioresorbable implants used in spine and orthopedic surgical procedures. These revenues were primarily related to orders during the three and nine months ended September 30, 2006 for our radiographically identifiable Spine System products, marketed under the name MYSTIQUE™, which Medtronic, our sole distributor of spine and orthopedic products, launched in the third quarter of 2005. Revenues in the third quarter of 2005 were dominated by pre-launch stocking orders for our MYSTIQUE™ products. However, subsequent to the product launch in the third quarter of 2005, Medtronic has substantially decreased its orders of this product. As a result of this decrease, we experienced negative profit margins for our MacroPore Biosurgery segment for the three and nine months ended September 30, 2006.

Note that Medtronic owns approximately 5.38% of our outstanding common stock as of September 30, 2006.

The future (2006): Our revenue from spine and orthopedic products is dependent upon the market's adoption of our technology, which is largely dependent upon Medtronic's marketing efforts and pricing strategies. Therefore our visibility of the size and timing of HYDROSORB™ and MYSTIQUE™ orders is limited. Since we rely on Medtronic's ability and commitment to build and expand the market share for our products and we have been disappointed in the past by their effort at such, it is possible that we will not receive more than minimal orders for the MYSTIQUE™ portion of the HYDROSORB™ product line during the remainder of 2006. Since it is unlikely that we will see significant sales of the current non-MYSTIQUE™ products any time in the future, it is likely that we will continue to see losses in our Medtronic-dependent MacroPore Biosurgery business going forward.

The majority of all product revenues are attributable to Medtronic as domestic Thin Film revenues ceased in 2004. This may change when commercialization of the Thin Film products in Japan occurs and we begin Thin Film shipments to Senko.

Cost of product revenues

Cost of product revenues relates to our MacroPore Biosurgery segment and includes material, manufacturing labor, overhead costs and an inventory provision. The following table summarizes the components of our cost of revenues for the three and nine months ended September 30, 2006 and 2005:

	For the three months ended September 30,				For the nine months ended September 30,			
	2006	2005	$ Differences	% Differences	2006	2005	$ Differences	% Differences
Cost of product revenues	$ 368,000	$ 796,000	$ (428,000)	(53.8)%	$ 1,208,000	$ 2,233,000	$ (1,025,000)	(45.9)%
Inventory provision	—	132,000	(132,000)	—	70,000	178,000	(108,000)	(60.7)%
Stock-based compensation	15,000	—	15,000	—	63,000	—	63,000	—
Total cost of product revenues	$ 383,000	$ 928,000	$ (545,000)	(58.7)%	$ 1,341,000	$ 2,411,000	$ (1,070,000)	(44.4)%
Total cost of product revenues as % of product revenues	288.0%	60.1%			123.4%	50.5%		

MacroPore Biosurgery:

- As our product revenues are currently generated only through sales of bioresorbable products, cost of revenues is related only to our MacroPore Biosurgery segment.

- Total cost of product revenues, as a percent of product revenues, increased by 581.7% and 344.4% for the three and nine months ended September 30, 2006, respectively, as compared to the same periods in 2005. The change for the three and nine months ended September 30, 2006 as compared to the same periods in 2005 was due primarily to fixed labor and overhead costs applied to sharply declining product revenues in the periods. As MacroPore Biosurgery product revenues have declined, gross margins have been negatively affected by fixed costs. In fact, for the three and nine months ended September 30, 2006, we experienced negative profit margins.

- In response to MacroPore Biosurgery's declining revenues, we are seeking to reduce expenses. We reduced our headcount by 18% in the third quarter of 2006. A large portion of the affected personnel related to the MacroPore Biosurgery segment.

- Excess manufacturing costs - that is, costs resulting from lower than "normal" production levels - expensed during the three and nine months ended September 30, 2006 were $346,000 and $988,000 as compared to $341,000 and $532,000 for the same periods in 2005.

- Cost of product revenues in 2006 includes approximately $15,000 and $63,000 of stock-based compensation expense for the three and nine months ended September 30, 2006, respectively. There was no similar expense in 2005. For further details, see stock-based compensation discussion below.

- During the third quarters of 2006 and 2005, we recorded provisions of $0 and $132,000, respectively, related to excess inventory.

The future (2006). The lack of orders from Medtronic deprives us of economies of scale and has and will continue to negatively impact our margins. We do not expect demand for our HYDROSORB™ MYSTIQUE™ products, which depends largely on Medtronic's marketing efforts, to increase during the remainder of 2006. If this proves to be true, this segment will remain unprofitable and we will continue to incur excess manufacturing costs similar to amounts we recorded in the first nine months of the year.

It appears that the spine and orthopedics business is not succeeding under our stewardship. As a result, our Board of Directors has decided to divest and is actively seeking a buyer (or buyers) for these assets.

Development revenues

The following table summarizes the components of our development revenues for the three and nine months ended September 30, 2006 and 2005:

	For the three months ended September 30,				For the nine months ended September 30,			
	2006	2005	$ Differences	% Differences	2006	2005	$ Differences	% Differences
Regenerative cell technology:								
Development (Olympus)	$ —	$ —	$ —	—	$ 683,000	$ —	$ 683,000	—
Research grant (NIH)	303,000	25,000	278,000	1,112.0%	310,000	110,000	200,000	181.8%
Regenerative cell storage services and other	47,000	2,000	45,000	2,250.0%	103,000	6,000	97,000	1,616.7%
Total regenerative cell technology	350,000	27,000	323,000	1,196.3%	1,096,000	116,000	980,000	844.8%
MacroPore Biosurgery:								
Development (Senko)	1,000	11,000	(10,000)	(90.9)%	149,000	20,000	129,000	645.0%
Total development revenues	$ 351,000	$ 38,000	$ 313,000	823.7%	$ 1,245,000	$ 136,000	$ 1,109,000	815.4%

Regenerative cell technology:

- We recognize deferred revenues, related party, as development revenue when certain performance obligations are met (i.e., using a proportional performance approach). During the three and nine months ended September 30, 2006, we recognized $0 and $683,000 of revenue associated with our arrangements with Olympus. The revenue recognized in the first quarter of 2006 was a result of completion of a pre-clinical study and a milestone payment upon receipt of a CE mark for the first generation Celution™ System.

- The research grant revenue relates to our agreement with the National Institutes of Health ("NIH"). Under this arrangement, the NIH reimburses us for "qualifying expenditures" related to research on Adipose-Derived Cell Therapy for Myocardial Infarction. To receive funds under the grant arrangement, we are required to (i) demonstrate that we incurred "qualifying expenses," as defined in the grant agreement between the NIH and us, (ii) maintain a system of controls, whereby we can accurately track and report all expenditures related solely to research on Adipose-Derived Cell Therapy for Myocardial Infarction, and (iii) file appropriate forms and follow appropriate protocols established by the NIH.

  Our policy is to recognize revenues under the NIH grant arrangement as the lesser of (i) qualifying costs incurred (and not previously recognized), plus our allowable grant fees for which we are entitled to funding or (ii) the amount determined by comparing the outputs generated to date versus the total outputs expected to be achieved under the research arrangement.

  During the three and nine months ended September 30, 2006, we incurred $393,000 and $479,000 in expenditures, of which $303,000 and $310,000 were qualified. We recorded a total of $303,000 and $310,000 in revenues for the three and nine months ended September 30, 2006, respectively, which include allowable grant fees as well as cost reimbursements. During the three and nine months ended September 30, 2005, we incurred $25,000 and $108,000 of costs, of which all were qualified. We recorded a total of $25,000 and $110,000 in revenues for the three and nine months ended September 30, 2005, which includes $2,000 in allowable grant fees as well as cost reimbursements.

MacroPore Biosurgery:

Under a Distribution Agreement with Senko we are entitled to earn payments based on achieving the following defined milestones:

- Upon notifying Senko of completion of the initial regulatory application to the MHLW for the Thin Film product, we were entitled to a nonrefundable payment of $1,250,000. We so notified Senko on September 28, 2004, received payment in October of 2004, and recorded deferred revenues of $1,250,000. As of September 30, 2006, of the amount deferred, we have recognized development revenues of $358,000 ($149,000 in 2006, $51,000 in 2005, and $158,000 in 2004).

- Under this agreement, we also received a $1,500,000 license fee that was recorded as a component of deferred revenues in the accompanying balance sheet. We are also entitled to a nonrefundable payment of $250,000 once we achieve commercialization. Because the $1,500,000 in license fees are potentially refundable, such amounts will not be recognized as revenues until the refund rights expire. Specifically, half of the license fee is refundable if the parties agree commercialization is not achievable and a proportional amount is refundable if we terminate the arrangement, other than for material breach by Senko, before three years post-commercialization.

The future (2006): We expect that revenues from our regenerative cell technology segment will increase during the remainder of 2006. Specifically, we anticipate completing two pre-clinical studies and certain phases of our product development performance obligations during the remainder of 2006. If we are successful in achieving certain milestone points related to these activities, we will recognize approximately $7,000,000 in revenues in 2006. The exact timing of when amounts will be reported in revenue will depend on internal factors (for instance, our ability to complete the service obligations we have agreed to perform) as well as external considerations, including obtaining the necessary regulatory approvals for various therapeutic applications related to the Celution™ System.

We are entitled to receive up to $850,000 in grants related to Adipose-Derived Cell Therapy for Myocardial Infarction as defined by the NIH grant agreement for Phase II research. As of September 30, 2006, we have received and recognized all $850,000 of such funding.

We will continue to recognize revenue from the development work we are performing on behalf of Senko, based on the relative fair value of the milestones completed to the total efforts expected to be necessary to obtain regulatory clearance with the MHLW. Obtaining regulatory clearance with the MHLW for initial commercialization is expected in the fourth quarter of 2006 or early 2007. Accordingly, we expect to recognize approximately $1,142,000 (consisting of $892,000 in deferred revenues plus a non-refundable payment of $250,000 to be received upon commercialization) in revenues associated with this milestone arrangement. Moreover, we expect to recognize $500,000 per year associated with deferred Senko license fees over a three-year period following commercialization as the refund rights associated with the license payment expire.

Research and development expenses

Research and development expenses include costs associated with the design, development, testing and enhancement of our products, regulatory fees, the purchase of laboratory supplies, pre-clinical studies, and in 2006, clinical studies. The following table summarizes the components of our research and development expenses for the three and nine months ended September 30, 2006 and 2005:

	For the three months ended September 30,				For the nine months ended September 30,			
	2006	2005	$ Differences	% Differences	2006	2005	$ Differences	% Differences
Regenerative cell technology:								
Regenerative cell technology	$ 2,805,000	$ 3,293,000	$ (488,000)	(14.8)%	$ 9,785,000	$ 8,288,000	$ 1,497,000	18.1%
Joint Venture	1,866,000	—	1,866,000	—	4,732,000	—	4,732,000	—
Research grants (NIH)	302,000	25,000	277,000	1,108.0%	388,000	108,000	280,000	259.3%
Stock-based compensation	296,000	4,000	292,000	7,300.0%	837,000	67,000	770,000	1,149.3%
Total regenerative cell technology	5,269,000	3,322,000	1,947,000	58.6%	15,742,000	8,463,000	7,279,000	86.0%
MacroPore Biosurgery:								
Bioresorbable polymer implants	235,000	533,000	(298,000)	(55.9)%	824,000	1,907,000	(1,083,000)	(56.8)%
Development milestone-Senko	45,000	24,000	21,000	87.5%	159,000	91,000	68,000	74.7%
Stock-based compensation	3,000	112,000	(109,000)	(97.3)%	24,000	112,000	(88,000)	(78.6)%
Total MacroPore Biosurgery	283,000	669,000	(386,000)	(57.7)%	1,007,000	2,110,000	(1,103,000)	(52.3)%
Total research and development expenses	$ 5,552,000	$ 3,991,000	$ 1,561,000	39.1%	$ 16,749,000	$ 10,573,000	$ 6,176,000	58.4%

Regenerative cell technology:

- Regenerative cell technology expenses relate to the development of a technology platform that involves using adipose (fat) tissue as a source for autologous regenerative cells for therapeutic applications. These expenses, in conjunction with our continued development efforts related to our Celution™ System, result primarily from the broad expansion of our research and development efforts enabled by the funding we received from Olympus in 2005 and 2006. Labor-related expenses, not including stock-based compensation, increased by $305,000 and $2,031,000, respectively, for the three and nine months ended September 30, 2006 and 2005. Professional services expense, which includes preclinical study costs, increased by $467,000 and $1,326,000 for the three and nine months ended September 30, 2006 as compared to the same periods in 2005. Rent and utilities expense increased by $118,000 and $805,000 in the three and nine months ended September 2006 as compared to 2005 due to the addition of our new facility. Other supplies increased by $132,000 and $722,000 during the three and nine months ended September 30, 2006 as compared to 2005. Other notable increases included repairs and maintenance of $150,000 and $380,000 and depreciation expense increases of $129,000 and $417,000, for the three and nine months ended September 30, 2006, respectively, as compared to the same periods in 2005.

- Expenditures related to the Joint Venture with Olympus, which are included in the fluctuation analysis above, include costs that are necessary to support the commercialization of future generation devices based on our Celution™ System. These development activities include performing pre-clinical and clinical studies, seeking regulatory approval, and performing product development related to therapeutic applications for adipose stem and regenerative cells for multiple large markets. For the three and nine months ended September 30, 2006, costs associated with the development of the device were $1,866,000 and $4,732,000. These expenses were composed of $712,000 and $2,217,000 in labor and related benefits, $714,000 and $1,452,000 in consulting and other professional services, $335,000 and $774,000 in supplies and $105,000 and $289,000 in other miscellaneous expense, respectively. There were no comparable expenditures for the three and nine months ended September 30, 2005.

- In 2004, we entered into an agreement with the NIH to reimburse us for up to $950,000 (Phase I $100,000 and Phase II $850,000) in “qualifying expenditures” related to research on Adipose-Derived Cell Therapy for Myocardial Infarction. For the three and nine months ended September 30, 2006, we incurred $393,000 and $479,000 of direct expenses relating entirely to Phase II ($90,000 and $169,000 of which were not reimbursed, respectively). To date, we have incurred $1,125,000 of direct expenses ($186,000 of which were not reimbursed) relating to both Phases I and II of the agreement.

- Stock-based compensation for the regenerative cell technology segment of research and development was $296,000 and $837,000 for the three and nine months ended September 30, 2006, respectively. Stock-based compensation for the three and nine months ended September 30, 2005 was $4,000 and $67,000, respectively. See stock-based compensation discussion below for more details.

MacroPore Biosurgery:

- Our bioresorbable polymer surgical implants platform technology is used for development of spine and orthopedic products. The decrease in research and development costs associated with bioresorbable polymer implants for the three and nine months ended September 30, 2006 as compared with the same period in 2005 was due primarily to our shift in focus to our regenerative cell technology segment. Labor and related benefits expense decreased by $150,000 and $548,000 for the three and nine months ended September 30, 2006, respectively, as compared to the same periods in 2005. This was due to a redistribution of labor resources from one segment to the other as well as a reduction in force in the third quarter of 2006.

- Under a Distribution Agreement with Senko we are responsible for the completion of the initial regulatory application to the MHLW and commercialization of the Thin Film product line in Japan. Commercialization occurs when one or more Thin Film product registrations are completed with the MHLW. During the three and nine months ended September 30, 2006 we incurred $45,000 and $159,000, respectively, of expenses related to this regulatory and registration process. We incurred $24,000 and $91,000 of expenses for the same periods in 2005.

- Stock-based compensation for the MacroPore Biosurgery segment of research and development for the three and nine months ended September 30, 2006 was $3,000 and $24,000, respectively. Stock-based compensation for the three and nine months ended September 30, 2005 was $112,000 and $112,000, respectively. See stock-based compensation discussion below for more details.

The future (2006). Our strategy is to continue to increase our research and development efforts in the regenerative cell field and we anticipate expenditures in this area of research to total approximately $20,000,000 to $22,000,000 in 2006. We are researching therapies for cardiovascular disease, aesthetic and reconstructive surgery, gastrointestinal disorders and spine and orthopedic conditions. The expenditures will primarily relate to developing therapeutic applications and conducting preclinical and clinical studies on adipose-derived stem and regenerative cells.

We continue to reduce research and development expenditures in the bioresorbable platform technology, and they will continue to be significantly less than our regenerative cell business research and development expenditures. We anticipate minimal further expenditures in this area of research in the fourth quarter of 2006 given our increased focus on the regenerative cell business.

Sales and marketing expenses

Sales and marketing expenses include costs of marketing personnel, tradeshows, and promotional activities and materials. Medtronic is responsible for the distribution, marketing and sales support of our spine and orthopedic devices. The following table summarizes the components of our sales and marketing expenses for the three and nine months ended September 30, 2006 and 2005:

	For the three months ended September 30,				For the nine months ended September 30,			
	2006	2005	$ Differences	% Differences	2006	2005	$ Differences	% Differences
Regenerative cell technology:								
International sales and marketing	$ 310,000	$ 224,000	$ 86,000	38.4%	$ 910,000	$ 224,000	$ 686,000	306.3%
Stock-based compensation	263,000	—	263,000	—	451,000	—	451,000	—
Total regenerative cell technology	573,000	224,000	349,000	155.8%	1,361,000	224,000	1,137,000	507.6%
MacroPore Biosurgery:								
General corporate marketing	10,000	106,000	(96,000)	(90.6)%	140,000	357,000	(217,000)	(60.8)%
International sales and marketing	27,000	36,000	(9,000)	(25.0)%	74,000	513,000	(439,000)	(85.6)%
Stock-based compensation	—	113,000	(113,000)	—	9,000	113,000	(104,000)	(92.0)%
Total MacroPore Biosurgery	37,000	255,000	(218,000)	(85.5)%	223,000	983,000	(760,000)	(77.3)%
Total sales and marketing expenses	$ 610,000	$ 479,000	$ 131,000	27.3%	$ 1,584,000	$ 1,207,000	$ 377,000	31.2%

Regenerative Cell Technology:

- International sales and marketing expenditures for the three and nine months ended September 30, 2006, relate primarily to salaries expense for employees involved in business development. The main emphasis of these newly-formed functions is to seek strategic alliances and/or co-development partners for our regenerative cell technology, which we began to focus on in the third quarter of 2005.

- Stock-based compensation for the regenerative cell segment of sales and marketing for the three and nine months ended September 30, 2006 was $263,000 and $451,000, respectively. There was no similar expense in 2005. See stock-based compensation discussion below for more details.

MacroPore Biosurgery:

- General corporate marketing expenditures relate to expenditures for maintaining our corporate image and reputation within the research and surgical communities. The decreases in the three and nine month periods ended September 30, 2006 as compared to the same periods in 2005 were due to a shift in focus towards our regenerative cell technology marketing, which in turn prompted a reduction in headcount in biomaterials and general corporate marketing.

- International sales and marketing expenditures relate to costs associated with developing an international bioresorbable Thin Film distributor and supporting a bioresorbable Thin Film sales office in Japan. The decreased spending in 2006 as compared to 2005 relates to a significant headcount decrease in this marketing group as MHLW approval for commercialization has been delayed from our original expectation.

- Stock-based compensation for the MacroPore Biosurgery segment of sales and marketing for the three and nine months ended September 30, 2006 was $0 and $9,000, respectively. Stock-based compensation for the three and nine months ended September 30, 2005 was $113,000 and $113,000, respectively. See stock-based compensation discussion below for more details.

*The future***.** We project that general corporate marketing as well as our MacroPore Biosurgery international sales and marketing expenditures will remain reasonably stable for the remainder of 2006. We also expect sales and marketing expenditures related to the regenerative cell technology to increase as we continue and expand our pursuit of strategic alliances and co-development partners.

General and administrative expenses

General and administrative expenses include costs for administrative personnel, legal and other professional expenses and general corporate expenses. The following table summarizes the general and administrative expenses for the three and nine months ended September 30, 2006 and 2005:

	For the three months ended September 30,				For the nine months ended September 30,			
	2006	2005	$ Differences	% Differences	2006	2005	$ Differences	% Differences
General and administrative	$ 2,979,000	$ 3,017,000	$ (38,000)	(1.3)%	$ 8,737,000	$ 7,374,000	$ 1,363,000	18.5%
Stock-based compensation	202,000	112,000	90,000	80.4%	1,268,000	112,000	1,156,000	1,032.1%
Total general and administrative expenses	$ 3,181,000	$ 3,129,000	$ 52,000	1.7%	$ 10,005,000	$ 7,486,000	$ 2,519,000	33.6%

- During the three and nine months ended September 30, 2006, we accrued $487,000 related to 100,000 shares of stock to be issued to UC in the fourth quarter of 2006. This resulted from the amended contract between UC and us that was finalized in the third quarter of 2006. At the time the agreement was reached, the stock was trading at $4.87 per share.

- An overall decrease (excluding stock-based compensation) occurred in the third quarter of 2006 as compared to the same period in 2005. This was a result of the effort put forth by management to decrease costs, offset for the year by higher costs in the first and second quarters of 2006. Salaries and other related benefits (not including stock-based compensation) increased by $212,000 and $791,000 for the three and nine months ended September 30, 2006, respectively, as compared to the same periods in 2005. Travel and entertainment expense decreased by $93,000 and $30,000 for the three and nine months ended September 30, 2006. Depreciation expense increased by $4,000 and $97,000 for the three and nine months ended September 30, 2006.

- In the second quarter of 2006, we recorded an additional $118,000 of depreciation expense to accelerate the estimated remaining lives for certain assets determined to be no longer in use. These assets related to furniture and fixtures no longer in use due to our recent relocation as well as outdated computer software and related equipment. The assets belong to both our regenerative cell technology and MacroPore Biosurgery operating segments. We recorded the charge as an increase to general and administrative expenses. There was no similar charge for the same period in 2005.

- Stock-based compensation related to general and administrative expense for the three and nine months ended September 30, 2006 was $202,000 and $1,268,000, respectively. Stock-based compensation for the three and nine months ended September 30, 2005 was $112,000 and $112,000. See stock-based compensation discussion below for more details.

The future. We expect general and administrative expenses to remain steady or increase slightly in 2006, to approximately $12,000,000 to $14,000,000 in 2006. We are seeking ways to minimize the ratio of these expenses to research and development expenses. As a result, we have begun efforts to restrain general and administrative expense.

We have incurred, and expect to continue to incur, substantial legal expenses in connection with the University of Pittsburgh's 2004 lawsuit. Although we are not litigants and are not responsible for any settlement costs, if the University of Pittsburgh wins the lawsuit our license rights to the patent in question could be nullified or rendered non-exclusive and our regenerative cell strategy could be significantly affected. Further, as a result of the amended UC contract signed in the third quarter or 2006, we are responsible for all patent prosecution and litigation costs related to this lawsuit.

Stock-based compensation expenses

As noted previously, we adopted SFAS 123R on January 1, 2006. Prior period figures have not been restated and therefore are not comparable to the current year presentation.

The following table summarizes the components of our stock based compensation for the three and nine months ended September 30, 2006 and 2005:

	For the three months ended September 30,				For the nine months ended September 30,			
	2006	2005	$ Differences	% Differences	2006	2005	$ Differences	% Differences
Regenerative cell technology:								
Research and development related	$ 296,000	$ 4,000	$ 292,000	7,300.0%	$ 837,000	$ 67,000	$ 770,000	1,149.3%
Sales and marketing related	263,000	—	263,000	—	451,000	—	451,000	—
Total regenerative cell technology	559,000	4,000	555,000	13,875.0%	1,288,000	67,000	1,221,000	1,822.4%
MacroPore Biosurgery:								
Cost of product revenues	15,000	—	15,000	—	63,000	—	63,000	—
Research and development related	3,000	112,000	(109,000)	(97.3)%	24,000	112,000	(88,000)	(78.6)%
Sales and marketing related	—	113,000	(113,000)	—	9,000	113,000	(104,000)	(92.0)%
Total MacroPore Biosurgery	18,000	225,000	(207,000)	(92.0)%	96,000	225,000	(129,000)	(57.3)%
General and administrative related	202,000	112,000	90,000	80.4%	1,268,000	112,000	1,156,000	1,032.1%
Total stock based compensation	$ 779,000	$ 341,000	$ 438,000	128.4%	$ 2,652,000	$ 404,000	$ 2,248,000	556.4%

Regenerative cell technology:

- In the first quarter of 2006, we granted 2,500 shares of restricted common stock to a non-employee scientific advisor. Similarly, in the second quarter of 2005, we granted 20,000 shares of restricted common stock to a non-employee scientific advisor. Because the shares granted are not subject to additional future vesting or service requirements, the stock-based compensation expense of $18,000 recorded in the first quarter of 2006 (and $63,000 recorded in the second quarter of 2005) constitute the entire expenses related to these grants, and no future period charges will be reported. The stock is restricted only in that it cannot be sold for a specified period of time. There are no vesting requirements. The scientific advisors also receive cash consideration as services are performed.

- Of the $2,652,000 charge to stock-based compensation for the nine months ended September 30, 2006, $567,000 related to award modifications for the termination of the full-time employment of our former Senior Vice President of Finance and Administration in exchange for part-time employment and eliminations of the positions of Senior Vice President, Business Development, and Vice President, Marketing and Development, and the position of a less senior employee. The charge reflects the incremental fair value of the extended vested stock options (over the fair value of the original awards at the modification date), as well as compensation cost associated with the cancelled non-vested option awards that would have been recognized if the three individuals continued to vest in their options until the end of their employment term. There will be no further charges related these modifications.

The future (2006). We will continue to grant options (which will result in an expense) to our employees and, as appropriate, to non-employee service providers. In addition, previously-granted options will continue to vest in accordance with their terms. As of September 30, 2006, the total compensation cost related to non-vested stock options not yet recognized for all plans presented is approximately $4,341,000. These costs are expected to be recognized over a weighted average period of 1.91 years.

Change in fair value of option liabilities

The following is a table summarizing the change in fair value of option liabilities for the three and nine months ended September 30, 2006 and 2005:

	For the three months ended September 30,				For the nine months ended September 30,			
	2006	2005	$ Differences	% Differences	2006	2005	$ Differences	% Differences
Change in fair value of option liability	$ (574,000)	$ 924,000	$ (1,498,000)	(162.1)%	$ (3,714,000)	$ 984,000	$ (4,698,000)	(477.4)%
Change in fair value of put option liability	200,000	—	200,000	—	200,000	—	200,000	—
Total change in fair value of option liabilities	$ (374,000)	$ 924,000	$ (1,298,000)	(140.5)%	$ (3,514,000)	$ 984,000	$ (4,498,000)	(457.1)%

- We granted Olympus an option to acquire 2,200,000 shares of our common stock which expires December 31, 2006. The exercise price of the option shares is $10 per share. We have accounted for this grant as a liability because upon the exercise of the option, we will be required to deliver listed shares of our common stock to settle the option shares. In accordance with EITF 00-19, “Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock,” the fair value of this option has been re-measured at the end of each quarter, using the Black-Scholes option pricing model, with the movement in fair value reported in the statement of operations as a change in fair value of option liabilities. At September 30, 2006, the contractual term, fair market value, risk-free interest rate and volatility assumptions used in the Black-Scholes option pricing model were 3 months, 4.89% and 61.8%, respectively. The decline in the fair value of the option liability is due primarily to a shortened contractual term as the option moves closer to maturity.

- In reference to the Joint Venture, the Shareholders’ Agreement between Cytori and Olympus provides that in certain specified circumstances of insolvency or if we experience a change in control, Olympus will have the rights to (i) repurchase our interests in the Joint Venture at the fair value of such interests or (ii) sell its own interests in the Joint Venture to us at the higher of (a) $22,000,000 or (b) the Put's fair value. The Put value has been classified as a liability.

  The valuations of the Put were completed by an independent valuation firm using an option pricing theory based simulation analysis (i.e., a Monte Carlo simulation). The valuations are based on assumptions as of the valuation date with regard to the market value of Cytori and the estimated fair value of the Joint Venture, the expected correlation between the values of Cytori and the Joint Venture, the expected volatility of Cytori and the Joint Venture, the bankruptcy recovery rate for Cytori, the bankruptcy threshold for Cytori, the probability of a change of control event for Cytori, and the risk free rate.

The following assumptions were employed in estimating the value of the Put at September 30, 2006 (these assumptions were not materially different from those used in valuing the Put since November 4, 2005 and every quarter subsequent until the present):

- The expected volatilities of Cytori and the Joint Venture were assumed to be 63.2% and 69.1%, respectively,
- The bankruptcy recovery rate for Cytori was assumed to be 21%,
- The bankruptcy threshold for Cytori was assumed to be $10.78 million,
- The probability of a change of control event for Cytori was assumed to be 3.04%,
- The expected correlation between the fair values of Cytori and the Joint Venture in the future was assumed to be 99%, and
- The risk free rate was assumed to be 4.64%.

The future (2006). The 2,200,000 share option expires on December 31, 2006. Unless the option is exercised some time during the fourth quarter of 2006, the change from $17,000 in the third quarter to $0 option liability at December 31, 2006 will be reported in the statements of operations as changes in the fair value of option liabilities and no longer re-measured going forward.

The Put has no expiration date. Accordingly, we will continue to recognize a liability for the Put until it is exercised or until the arrangements with Olympus are amended.

Other income

The following table summarizes the gain on sale of assets for the three and nine months ended September 30, 2006 and 2005:

	For the three months ended September 30,				For the nine months ended September 30,			
	2006	2005	$ Differences	% Differences	2006	2005	$ Differences	% Differences
Gain on sale of assets	$ —	$ 5,526,000	$ (5,526,000)	—	$ —	$ 5,526,000	$ 5,526,000	—

The $5,526,000 gain on sale of assets recorded in September 2005 was related to the sale of the majority of our Thin Film product line. As part of the disposal arrangement, we agreed to complete certain performance obligations which prevented us from recognized the gain on sale of assets when the cash was initially received. In August 2005, following the settlement of arbitration proceedings related to the sale agreement with MAST, we were able to recognize the gain on sale of assets of $5,650,000 less $124,000 of related deferred costs, in the statement of operations.

The future (2006). No additional gains will be recognized related to this sale.

Financing items

The following table summarizes interest income, interest expense, and other income and expense for the three and nine months ended September 30, 2006 and 2005:

	For the three months ended September 30,				For the nine months ended September 30,			
	2006	2005	$ Differences	% Differences	2006	2005	$ Differences	% Differences
Interest income	$ 158,000	$ 99,000	$ 59,000	59.6%	$ 537,000	$ 208,000	$ 329,000	158.2%
Interest expense	(47,000)	(31,000)	(16,000)	51.6%	(158,000)	(107,000)	(51,000)	47.7%
Other income (expense)	(7,000)	(13,000)	6,000	(46.2)%	(13,000)	(52,000)	39,000	(75.0)%
Total	$ 104,000	$ 55,000	$ 49,000	89.1%	$ 366,000	$ 49,000	$ 317,000	646.9%

- Interest income increased from 2005 to 2006 due to a larger balance of funds available for investment, which was a result of the transactions with Olympus, as well as the sale of common stock in the third quarter. Interest expense increased due to a new promissory note executed late in 2005 for additional equipment financing.
- Other income (expense) represents changes in foreign currency exchange rates.

The future (2006). Interest income earned in 2006 will be dependent on our levels of funds available for investment as well as general economic conditions, but will exceed 2005 overall. Interest expense will increase in 2006 due to the additional promissory note executed late in 2005.

Equity loss from investment in Joint Venture

The following table summarizes equity loss from investment in joint venture for the three and nine months ended September 30, 2006 and 2005:

	For the three months ended September 30,				For the nine months ended September 30,			
	2006	2005	$ Differences	% Differences	2006	2005	$ Differences	% Differences
Equity loss in investment	$ (3,000)	$ —	$ (3,000)	—	$ (68,000)	$ —	$ (68,000)	—

The loss in 2006 relates entirely to our 50% equity interest in the Joint Venture, which we account for using the equity method of accounting.

The future. We do not expect to recognize significant losses from the activities of the Joint Venture in the foreseeable future. Over the next two to three years, the Joint Venture is expected to incur only modest general and administrative expenses, which we will likely (but have no obligation to) fund jointly with Olympus.

Liquidity and Capital Resources

Short-term and long-term liquidity

The following is a summary of our key liquidity measures at September 30, 2006 and December 31, 2005:

	September 30, 2006	December 31, 2005	$ Differences	% Differences
Cash and cash equivalents	$ 13,615,000	$ 8,007,000	$ 5,608,000	70.0%
Short-term investments, available for sale	4,834,000	7,838,000	(3,004,000)	(38.3)%
Total cash and cash equivalents and short-term investments, available for sale	18,449,000	15,845,000	2,604,000	16.4%
Current assets	19,543,000	17,540,000	2,003,000	11.4%
Current liabilities	5,736,000	7,081,000	(1,345,000)	(19.0)%
Working capital	$ 13,807,000	$ 10,459,000	$ 3,348,000	32.0%

In order to provide greater financial flexibility and liquidity, and in view of the substantial cash needs of our regenerative cell business during its development stage, we will need to raise additional capital (notwithstanding the proceeds received from the Olympus collaboration agreements, which were entered into in November 2005). We have put into place a shelf registration statement, under which we can, from time to time, seek to sell up to $50,000,000 of registered equity securities. In the third quarter of 2006, we received net proceeds of $16,400,000 from the sale of registered common stock pursuant to this registration statement, of which Olympus purchased $11,000,000; the remaining securities were purchased by other institutional investors. We are also implementing certain cost containment measures and are considering divestment and other strategic alternatives for our spine and orthopedics business. With consideration of these endeavors as well as existing funds, cash generated by operations, and other accessible sources of financing, we believe our cash position is adequate to satisfy our working capital, capital expenditures, debt service and other financial commitments at least through September 30, 2007.

From inception to September 30, 2006, we have financed our operations primarily by:

- Issuing our stock,
- Generating revenues,
- Selling the CMF product line in September 2002,
- Selling the Thin Film product line (except for the territory of Japan), in May 2004,
- Entering into a Distribution Agreement for the distribution rights to Thin Film in Japan, in which we received an upfront license fee in July 2004 and an initial development milestone payment in October 2004,
- Obtaining a modest amount of capital equipment long-term financing,
- Closing a Stock Purchase Agreement with Olympus in May 2005,
- Entering into a collaborative arrangement with Olympus in November 2005, including the formation of a joint venture called Olympus-Cytori, Inc.,

- Receiving funds in exchange for granting Olympus an exclusive right to negotiate for gastrointestinal-related applications in February 2006, and

- Issuing $16,800,000 of registered common stock under our shelf registration statement in August 2006.

We increased our cash position by $11,000,000 in May 2005 through a common stock purchase agreement we entered into with Olympus in April 2005. This agreement covers the sale of 1,100,000 shares of our common stock to Olympus. Also as part of the agreement, we granted Olympus an option that expires December 31, 2006 to purchase an additional 2,200,000 shares of common stock at $10.00 per share.

Furthermore, we entered into a strategic development and manufacturing joint venture as well as other agreements with Olympus in November 2005. Under the collaborative arrangements, we formed the Joint Venture with Olympus to develop and manufacture future generation devices based on our Celution™ System. Pursuant to the terms of the agreements, we received $11,000,000 in cash upon closing in the fourth quarter of 2005; this cash is incremental to the proceeds received under the Olympus equity investment described above.

In January 2006, we also received an additional $11,000,000 upon our receipt of a CE mark for the first generation Celution™ System and received an additional $1,500,000 in the first half of 2006 in exchange for the grant to Olympus of an exclusive right to negotiate a commercialization collaboration for the use of adipose stem and regenerative cells for a specific therapeutic area outside of cardiovascular disease. We may receive more proceeds if Olympus decides to exercise its option to purchase 2,200,000 shares of our common stock.

In August 2006, we sold 2,918,255 shares of our common stock at $5.75 per share for an aggregate of approximately $16,800,000. Olympus purchased $11,000,000 of these shares and the remaining balance was purchased by certain institutional investors. We received net proceeds of approximately $16,400,000, net of related offering costs and fees.

We don’t expect significant further capital expenditures in 2006 beyond those already incurred to date; however, if necessary, we may borrow under our Amended Master Security Agreement.

Any excess funds will be invested in short-term available-for-sale investments.

Our capital requirements for 2006 and beyond will depend on numerous factors, including the resources we devote to developing and supporting our investigational cell therapy products, market acceptance of our developed products, regulatory approvals and other factors. We expect to incur research and development expenses at high levels in our regenerative cell platform for an extended period of time and have therefore positioned ourselves to expand our cash position through actively pursuing co-development and marketing agreements, research grants, and licensing agreements related to our regenerative cell technology platform. Further, we are actively seeking a buyer (or buyers) for our remaining MacroPore Biosurgery assets as a means to fund our continuing efforts in this platform. This decision is based on the change in our strategic focus as well as the continuing negative profit margins being realized from the MacroPore Biosurgery segment. We expect to complete the disposal no later than the third quarter of 2007.

The following summarizes our contractual obligations and other commitments at September 30, 2006, and the effect such obligations could have on our liquidity and cash flow in future periods:

	Payments due by period				
Contractual Obligations	**Total**	**Less than 1 year**	**1 - 3 years**	**3 - 5 years**	**More than 5 years**
Long-term obligations	$ 1,796,000	$ 886,000	$ 910,000	$ —	$ —
Interest commitment on long-term obligations	211,000	139,000	72,000	—	—
Operating lease obligations	6,251,000	2,086,000	4,165,000	—	—
Research study obligations	1,283,000	1,225,000	58,000	—	—
Total	$ 9,541,000	$ 4,336,000	$ 5,205,000	$ —	$ —

Cash (used in) provided by operating, investing and financing activities for the nine months ended September 30, 2006 and 2005, is summarized as follows:

	For the nine months ended September 30,	
	2006	**2005**
Net cash used in operating activities	$ (11,471,000)	$ (5,494,000)
Net cash provided by investing activities	622,000	2,252,000
Net cash provided by financing activities	16,457,000	2,677,000

Operating activities

Net cash used in operating activities for the nine months ended September 30, 2006 resulted from our $23,535,000 net loss, adjusted for the $11,000,000 cash we received in 2006 from the Joint Venture upon obtaining the CE Mark in the first quarter of 2006 and $1,605,000 of non-cash depreciation and amortization, along with other changes in working capital due to timing of product shipments (accounts receivable) and payment of liabilities.

Net cash used in operating activities for the nine months ended September 30, 2005 resulted from our net loss of $12,174,000, adjusted for material non-cash activities, such as the gain on sale of assets, as well as changes in working capital due to the timing of product shipments (accounts receivable) and payment of liabilities.

Operating losses for both periods resulted largely from expenses related to our regenerative medicine research and development efforts. The $5,977,000 increased use of cash for operating activities was due primarily to the decline in sales to Medtronic, combined with an overall increase in research and development expenditures.

Investing activities

Net cash provided by investing activities for the nine months ended September 30, 2006 resulted primarily from expenditures for leasehold improvements, offset in part by the net proceeds from the sale of short-term investments.

Net cash provided by investing activities for the nine months ended September 30, 2005 resulted primarily from the sale and maturity of our short-term investments, the proceeds from which were used to fund operating activities during the first nine months of 2005.

Capital spending is essential to our product innovation initiatives and to maintain our operational capabilities. For the nine months ended September 30, 2006 and 2005, we used cash to purchase $2,214,000 and $1,052,000, respectively, of property and equipment to support manufacturing of our bioresorbable implants and for the research and development of the regenerative cell technology platform. The increase in 2006 capital spending was caused primarily by expenditures for leasehold improvements made to our new facilities.

Financing Activities

The net cash provided by financing activities for the nine months ended September 30, 2006 related mainly to the issuance of 2,918,255 shares of our common stock in exchange for $16,800,000. It was also related to the exercise of employee stock options and was to some extent offset by the principal payments on long-term obligations.

The net cash provided by financing activities for the nine months ended September 30, 2005 related mainly to the sale of common stock to Olympus for $11,000,000. The composition of the $11,000,000 in proceeds included: $3,003,000 for the sale of common stock, $186,000 for the issuance of an option, which was recorded in financing activities, and $7,811,000 for the issuance of common stock and options in excess of fair market value, which we have characterized as deferred revenues, related party, and recorded in operating activities.

Critical Accounting Policies and Significant Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires us to make estimates and assumptions that affect the reported amounts of our assets, liabilities, revenues and expenses, and that affect our recognition and disclosure of contingent assets and liabilities.

While our estimates are based on assumptions we consider reasonable at the time they were made, our actual results may differ from our estimates, perhaps significantly. If results differ materially from our estimates, we will make adjustments to our financial statements prospectively as we become aware of the necessity for an adjustment.

We believe it is important for you to understand our most critical accounting policies. These are our policies that require us to make our most significant judgments and, as a result, could have the greatest impact on our future financial results.

Revenue Recognition

We derive our revenue from a number of different sources, including but not limited to:

- Product sales,
- Payments under license or distribution agreements, and
- Fees for achieving certain defined milestones under research and/or development arrangements.

Many of our revenue generating arrangements are relatively simple in nature, meaning that there is little judgment necessary with regard to the timing of when we recognize revenues or how such revenues are presented in the financial statements.

However, we have also entered into more complex arrangements, including but not limited to our contracts with Olympus, Senko, and the NIH. Moreover, some of our non-recurring transactions, such as our disposition of the majority of our Thin Film business to MAST, contain elements that relate to our core revenue producing activities.

As a result, some of our most critical accounting judgments relate to the identification, timing, and presentation of revenue related activities. These critical judgments are discussed further in the paragraphs that follow.

Multiple-elements

Some of our revenue generating arrangements contain a number of distinct revenue streams, known as “elements.” For example, our Distribution Agreement with Senko contains direct or indirect future revenue streams related to:

- A distribution license fee (which was paid at the outset of the arrangement),
- Milestone payments for achieving commercialization of the Thin Film product line in Japan,
- Training for representatives of Senko,
- Sales of Thin Film products to Senko, and
- Payments in the nature of royalties on future product sales made by Senko to its end customers.

Emerging Issues Task Force Issue 00-21, “Revenue Arrangements with Multiple Deliverables” (“EITF 00-21”), governs whether each of the above elements in the arrangement should be accounted for individually, or whether the entire contract should be treated as a single unit of accounting.

EITF 00-21 indicates that individual elements may be separately accounted for only when:

- The delivered element has stand alone value to the customer,
- There is objective evidence of the fair value of the remaining undelivered elements, and
- If the arrangement contains a general right of return related to any products delivered, delivery of the remaining goods and services is probable and within the complete control of the seller.

In the case of the Senko Distribution Agreement, we determined that (a) the milestones payments for achieving commercialization and (b) the future sale of Thin Film products to Senko were “separable” elements. That is, each of these elements, upon delivery, will have stand alone value to Senko and there will be objective evidence of the fair value of any remaining undelivered elements at that time. The arrangement does not contain any general right of return, and so this point is not relevant to our analysis.

On the other hand, we concluded that (a) the upfront distribution license fee, (b) the revenues from training for representatives of Senko, and (c) the payments in the form of royalties on future product sales are not separable elements under EITF 00-21.

In arriving at our conclusions, we had to consider whether our customer, Senko, would receive stand alone value from each delivered element. We also, in some cases, had to look to third party evidence to support the fair value of certain undelivered elements - notably, training - since we as a company do not routinely deliver this service on a stand alone basis. Finally, we had to make assumptions about how the non-separable elements of the arrangement are earned, particularly the estimated period over which Senko will benefit from the arrangement (refer to the “Recognition” discussion below for further background).

We also agreed to perform multiple services under the November 4, 2005 agreements we signed with Olympus, including:

- Granting the Joint Venture (which Olympus is considered to control) an exclusive and perpetual license to our device technology, including the Celution™ System and certain related intellectual property; and
- Performing development activities in relation to certain therapeutic applications associated with our Celution™ System, including completing pre-clinical and clinical trials, seeking regulatory approval as appropriate, and assisting with product development.

Following commercialization of the Celution™ System, we will provide monthly forecasts, specifying the quantities of each category of devices that we intend to purchase from the Joint Venture, at formula-based prices, over a rolling six-month period. Although we are not subject to any minimum purchase requirements, we are obliged to buy a defined percentage of the products forecasted by us in such reports. However, this guarantee will trigger only upon the development of a commercializable device by the Joint Venture. Moreover, we effectively control the number of devices we will agree to purchase, since the guaranteed quantities will be derived from monthly forecasts prepared by us.

We concluded that the license and development services must be accounted for as a single unit of accounting. In reaching this conclusion, we determined that the license would not have stand alone value to the Joint Venture. This is because Cytori is the only party that could be reasonably expected to perform the development services- including pre-clinical and clinical studies, regulatory filings, and product development-necessary for the Joint Venture to derive any value from the license.

Recognition

Besides determining whether to account separately for components of a multiple-element arrangement, we also use judgment in determining the appropriate accounting period in which to recognize revenues that we believe (a) have been earned and (b) are realizable. The following describes some of the recognition issues we have considered during the reporting period.

- Upfront License Fees/Milestones

  - As part of the Senko Distribution Agreement, we received an upfront license fee upon execution of the arrangement, which, as noted previously, was not separable under EITF 00-21. Accordingly, the license has been combined with the development (milestones) element, which was separable, to form a single accounting unit. This single element of $3,000,000 in fees includes $1,500,000 which is potentially refundable. We have recognized, and will continue to recognize the non-contingent fees allocated to this combined element as revenues as we complete each of the performance obligations associated with the milestones component of this combined deliverable. Note that the timing of when we have recognized revenues to date does not correspond with the cash we received upon achieving certain milestones. For example, the first such milestone payment for $1,250,000 became payable to us when we filed a commercialization application with the Japanese regulatory authorities. However, we determined that the payment received was not commensurate with the level of effort expended, particularly when compared with other steps we believe are necessary to commercialize the Thin Film product line in Japan. Accordingly, we did not recognize the entire $1,250,000 received as revenues, but instead all but $358,000 of this amount is classified as deferred revenues. The $358,000 ($149,000 in 2006, $51,000 in 2005 and $158,000 in 2004) was recognized as development revenues based on our estimates of the level of effort expended for completed milestones as compared with the total level of effort we expect to incur under the arrangement to successfully achieve regulatory approval of the Thin Film product line in Japan. These estimates were subject to judgment and there may be changes in estimates regarding the total level of effort as we continue to seek regulatory approval. In fact there can be no assurance that commercialization in Japan will ever be achieved, although our latest understanding is that regulatory approval will be received during the remainder of 2006 or early 2007.

  - We also received upfront fees as part of the Olympus arrangements (although, unlike in the Senko agreement, these fees were non-refundable). Specifically, in exchange for an upfront fee, we granted the Joint Venture an exclusive, perpetual license to certain of our intellectual property and agreed to perform additional development activities. This upfront fee has been recorded in the liability account entitled deferred revenues, related party, on our consolidated balance sheet. Similar to the Senko agreement, we have elected an accounting policy to recognize revenues from the combined license/development accounting unit as we perform the development services, as this represents our final obligation underlying the combined accounting unit. Specifically, we plan to recognize revenues from the license/development accounting unit using a “proportional performance” methodology, resulting in the de-recognition of amounts recorded in the deferred revenues, related party, account as we complete various milestones underlying the development services. For instance, we plan to recognize some of the deferred revenues, related party as revenues, related party, when we complete a pre-clinical trial, or obtain regulatory approval in a specific jurisdiction. Determining what portion of the deferred revenues, related party balance to recognize as each milestone is completed involves substantial judgment. In allocating the balance of the deferred revenues, related party to various milestones, we had in-depth discussions with our operations personnel regarding the relative value of each milestone to the Joint Venture and Olympus. We also considered the cost of completing each milestone relative to the total costs we plan to incur in completing all of the development activities, since we believe that the relative cost of completing a milestone is a reasonable proxy for its fair value. The accounting policy described above could result in revenues being recorded in an earlier accounting period than had other judgments or assumptions been made by us.

- Government Grants

  - We are eligible to receive grants from the NIH related to our research on adipose derived cell therapy to treat myocardial infarctions. There are no specific standards under U.S. GAAP that prescribe the recognition or classification of these grants in the statement of operations. Absent such guidance, we have established an accounting policy to recognize NIH grant revenues at the lesser of:

    - Qualifying costs incurred (and not previously recognized), plus any allowable grant fees, for which Cytori is entitled to grant funding; or,

    - The amount determined by comparing the research outputs generated to date versus the total outputs that are expected to be achieved under the entire arrangement.

  - Our accounting policy could theoretically defer revenue recognition beyond the period in which we have earned the rights to such fees. However, we selected this accounting policy to counteract the possibility of recognizing revenues from the NIH arrangement too early. For instance, if our policy permitted revenues to be recognized solely as qualifying costs were incurred, we could alter the amount of revenue recognized by incurring more or less cost in a given period, irrespective of whether these costs correlate to the research outputs generated. On the other hand, if revenue recognition were based on output measures alone, it would be possible to recognize revenue in excess of costs actually incurred; this is not appropriate since qualifying costs remain the basis of our funding under the NIH grant. The application of our accounting policy, nonetheless, involves significant judgment, particularly in estimating the percentage of outputs realized to date versus the total outputs expected to be achieved under the grant arrangement.

- Back-up Supply Arrangement

  - We agreed to serve as a back-up supplier of products in connection with our dispositions of specific Thin Film assets to MAST. Specifically, we agreed to supply Thin Film product to MAST at our cost for a defined period of time. When we actually delivered products under the back-up supply arrangements in 2005, however, we recognized revenues in the financial statements at the estimated selling price which we would receive in the marketplace. We used judgment, based on historical data and expectations about future market trends, in determining the estimated market selling price of products subject to the back-up supply arrangements. The amount of the deferred gain recognized as revenue is equal to the excess of the fair value of products sold, based on historical selling prices of similar products, over our manufacturing cost.

Presentation

We have presented amounts earned under our NIH research arrangement as research grant revenue. We believe that the activities underlying the NIH agreement constitute a portion of our ongoing major or central operations. Moreover, the government obtains rights under the arrangement, in the same manner (but perhaps not to the same extent) as a commercial customer that similarly contracts with us to perform research activities. For instance, the government and any authorized third parties may use our federally funded research and/or inventions without payment of royalties to us.

Goodwill Impairment Testing

In late 2002, we purchased StemSource, Inc. and recognized over $4,600,000 in goodwill associated with the acquisition, of which $4,387,000 remains on our balance sheet as of September 30, 2006. As required by Statement of Financial Accounting Standard No. 142, "Goodwill and Other Intangible Assets" ("SFAS 142"), we must test this goodwill at least annually for impairment as well as when an event occurs or circumstances change such that it is reasonable possible that impairment may exist. Moreover, this testing must be performed at a level of the organization known as the reporting unit. A reporting unit is at least the same level as a company's operating segments, and sometimes even one level lower.

Specifically, the process for testing goodwill for impairment under SFAS 142 involves the following steps:

- Company assets and liabilities, including goodwill, are allocated to each reporting unit for purposes of completing the goodwill impairment test.
- The carrying value of each reporting unit - that is, the sum of all of the net assets allocated to the reporting unit - is then compared to its fair value.
- If the fair value of the reporting unit is lower than its carrying amount, goodwill may be impaired - additional testing is required.

When we last completed our goodwill impairment testing in 2005, the fair values of our two reporting units each exceeded their respective carrying values. Accordingly, we determined that none of our reported goodwill was impaired.

The application of the goodwill impairment test involves a substantial amount of judgment. For instance, SFAS 142 requires that assets and liabilities be assigned to a reporting unit if both of the following criteria are met:

- The asset will be employed in or the liability relates to the operations of a reporting unit.
- The asset or liability will be considered in determining the fair value of the reporting unit.

We developed mechanisms to assign company-wide assets like shared property and equipment, as well as company-wide obligations such as borrowings under our GE Loan Facility, to our two reporting units. In some cases, certain assets were not allocable to either reporting unit and were left unassigned.

The most complex and challenging asset to assign to each reporting unit was our acquired goodwill. As noted previously, all of our recorded goodwill was generated in connection with our acquisition of StemSource in 2002. All of the StemSource assets and liabilities still on hand at our 2004 testing date were allocated to our regenerative cell reporting unit. However, when we first acquired StemSource, we determined that a portion of the goodwill related to the MacroPore Biosurgery reporting unit. The amount of goodwill allocated represented our best estimate of the synergies (notably future cost savings from shared research and development activities) that the MacroPore Biosurgery reporting unit would obtain by virtue of the acquisition.

Finally, with the consultation and assistance of a third party, we estimated the fair value of our reporting units by using various estimation techniques. In particular, in 2005, we estimated the fair value of our MacroPore Biosurgery reporting unit based on an equal weighting of the market values of comparable enterprises and discounted projections of estimated future cash flows. Clearly, identifying comparable companies and estimating future cash flows as well as appropriate discount rates involve judgment. On the contrary, we estimated the fair value of our regenerative cell reporting unit solely using an income approach, as we believe there are no comparable enterprises on which to base a valuation. The assumptions underlying this valuation method involve a substantial amount of judgment, particularly since our regenerative cell business has yet to generate any revenues and does not have a commercially viable product.

Again, the manner in which we assigned assets, liabilities, and goodwill to our reporting units, as well as how we determined the fair value of such reporting units, involves significant uncertainties and estimates. The judgments employed may have an effect on whether a goodwill impairment loss is recognized.

Dispositions

In 2004, we sold most of the assets and intellectual property rights in our (non-Japan) Thin Film product line to MAST.

As is common in the life sciences industry, the sale agreements contained provisions beyond the simple transfer of net assets to the acquiring enterprises for a fixed price. Specifically, as part of the arrangement, we also agreed to perform the following services:

- Provide training to MAST personnel on production and other aspects of the Thin Film product lines, and
- Provide a back-up supply of Thin Film products to MAST, at cost, for a specified period of time.

Disposing of assets and product lines is not one of our core ongoing or central activities. Accordingly, determining the appropriate accounting for these transactions involved some of our most difficult, subjective and complex judgments. In particular, we made assumptions around the appropriate manner and timing in which to recognize the gain on disposal for each transaction in the statement of operations. Moreover, we considered whether the dispositions should be reflected as discontinued operations in accordance with Statement of Financial Accounting Standard No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets."

We initially deferred recognition of the gain related to our disposition of certain Thin Film assets, which occurred in May 2004. Again, the Asset Purchase Agreement governing the Thin Film sale obligated us to perform certain actions for the benefit of the buyer - MAST - for a defined period of time, such as serving as a back-up supplier. We concluded, due to the arbitration proceedings settled in August 2005, that we completed our remaining performance obligations during the third quarter of 2005. Accordingly, we recognized the remaining deferred gain on sale of assets as gain on sale of assets.

We also recognized a portion of the deferred gain when we sold products to MAST under the back-up supply agreement. Refer to the "Revenue Recognition" section of this Critical Accounting Policies and Significant Estimates discussion for further details.

Variable Interest Entity (Olympus-Cytori Joint Venture)

FASB Interpretation No. 46 (revised 2003), "Consolidation of Variable Interest Entities - An Interpretation of ARB No. 51" ("FIN 46R") requires a variable interest entity ("VIE") to be consolidated by its primary beneficiary. Evaluating whether an entity is a VIE and determining its primary beneficiary involves significant judgment.

In concluding that the Joint Venture was a VIE, we considered the following factors:

- Under FIN 46R, an entity is a VIE if it has insufficient equity to finance its activities. We recognized that the initial cash contributed to the Joint Venture formed by Olympus and Cytori ($30,000,000) would be completely utilized by the first quarter of 2006. Moreover, it was highly unlikely that the Joint Venture would be able to obtain the necessary financing from third party lenders without additional subordinated financial support - such as personal guarantees by one or both of the Joint Venture stockholders. Accordingly, the joint venture will require additional financial support from Olympus and Cytori to finance its ongoing operations, indicating that the Joint Venture is a VIE. In fact, in the first quarter of 2006, both we and Olympus contributed $150,000 each to fund the Joint Venture's ongoing operations.

- Moreover, Olympus has a contingent put option that would, in specified circumstances, require Cytori to purchase Olympus's interests in the Joint Venture for a fixed amount of $22,000,000. Accordingly, Olympus is protected in some circumstances from absorbing all expected losses in the Joint Venture. Under FIN 46R, this means that Olympus may not be an "at-risk" equity holder, although Olympus clearly has decision rights over the operations of the Joint Venture.

Because the Joint Venture is undercapitalized, and because one of the Joint Venture's decision makers may be protected from losses, we have determined that the Joint Venture is a VIE under FIN 46R. Because of the complexities in applying FIN 46R, it is reasonable to expect that others may reach a different conclusion.

As noted previously, a VIE is consolidated by its primary beneficiary. The primary beneficiary is defined in FIN 46R as the entity that would absorb the majority of the VIE's expected losses or be entitled to receive the majority of the VIE's residual returns (or both).

Significant judgment was involved in determining the primary beneficiary of the Joint Venture. Under FIN 46R, we believe that Olympus and Cytori are "de facto agents" and, together, will absorb more than 50% of the Joint Venture's expected losses and residual returns. Ultimately, we concluded that Olympus, and not Cytori, was the party most closely related with the joint venture and, hence, its primary beneficiary. Our conclusion was based on the following factors:

- The business operations of the Joint Venture will be most closely aligned to those of Olympus (i.e., the manufacture of devices).

- Olympus controls the Board of Directors, as well as the day-to-day operations of the Joint Venture.

The application of FIN 46R involves substantial judgment, and others may arrive at a conclusion that Cytori should consolidate the Joint Venture. Had we consolidated the Joint Venture, though, there would be no effect on our net income or shareholders' equity at September 30, 2006 or for the quarter and nine months then ended. However, certain balance sheet and income statement captions would have been presented in a different manner. For instance, we would not have presented a single line item entitled investment in joint venture in our balance sheet but, instead, would have performed a line by line consolidation of each of the Joint Venture's accounts into our financial statements.

Recent Accounting Pronouncements

In February 2006, the FASB issued Statement of Financial Accounting Standards No. 155, "Accounting for Certain Hybrid Instruments - An Amendment of FASB Statements Nos. 133 and 140" ("SFAS 155"). SFAS 155 allows companies to elect an accounting policy choice for so-called "hybrid instruments". A hybrid instrument is a contract that contains one or more embedded derivatives. In many cases, Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedge Accounting" ("SFAS 133") requires that an embedded derivative be separated from the "host contract" and accounted for at fair value in the financial statements. SFAS 155 removes the mandatory requirement to bifurcate an embedded derivative if the holder elects to account for the entire instrument - that is, both the host contract and the embedded derivative - at fair value, with subsequent changes in fair value recognized in earnings. SFAS 155 is effective for all hybrid instruments acquired or issued on or after September 15, 2006 and may be applied to hybrid financial instruments that had been bifurcated under SFAS 133 in the past. We do not believe that the adoption of SFAS 155 will have a significant effect on our financial statements.

In June 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" ("FIN 48"). This is an interpretation of Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes. It prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. This interpretation is effective for fiscal years beginning after December 15, 2006. We do not believe that the adoption of FIN 48 will have a significant effect on our financial statements.

In June 2006, the FASB ratified the consensus reached by the Emerging Issues Task Force on Issue No. 06-3, "How Sales Taxes Collected From Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement" ("EITF 06-3"). EITF 06-3 requires a company to disclose its accounting policy (i.e. gross vs. net basis) relating to the presentation of taxes within the scope of EITF 06-3. Furthermore, for taxes reported on a gross basis, an enterprise should disclose the amounts of those taxes in interim and annual financial statements for each period for which an income statement is presented. The guidance is effective for all periods beginning after December 15, 2006. We do not believe that the adoption of EITF 06-3 will have a significant effect on our financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements" ("SAB 108"). SAB 108 provides interpretive guidance on how the effects of prior-year uncorrected misstatements should be considered when quantifying misstatements in the current year financial statements. SAB 108 requires registrants to quantify misstatements using both an income statement ("rollover") and balance sheet ("iron curtain") approach and evaluate whether either approach results in a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. If prior year errors that had been previously considered immaterial now are considered material based on either approach, no restatement is required so long as management properly applied its previous approach and all relevant facts and circumstances were considered. If prior years are not restated, the cumulative effect adjustment is recorded in opening accumulated earnings (deficit) as of the beginning of the fiscal year of adoption. SAB 108 is effective for fiscal years ending on or after November 15, 2006, with earlier adoption encouraged. We do not believe that the adoption of SAB 108 will have a significant effect on our financial statements.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" ("SFAS 157"). SFAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosure of fair value measurements. SFAS 157 applies under other accounting pronouncements that require or permit fair value measurements and accordingly, does not require any new fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. We do not believe that the adoption of SFAS 157 will have a significant effect on our financial statements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to market risk related to fluctuations in interest rates and in foreign currency exchange rates.

Interest Rate Exposure

We are not subject to market risk due to fluctuations in interest rates on our long-term obligations as they bear a fixed rate of interest. Our exposure relates primarily to short-term investments. These short-term investments, reported at an aggregate fair market value of $4,834,000 as of September 30, 2006, consist primarily of investments in debt instruments of financial institutions and corporations with strong credit ratings and United States government obligations. These securities are subject to market rate risk as their fair value will fall if market interest rates increase. If market interest rates were to increase immediately and uniformly by 100 basis points from the levels prevailing at September 30, 2006, for example, and assuming average investment duration of seven months, the fair value of the portfolio would not decline by a material amount. We do not use derivative financial instruments to mitigate the risk inherent in these securities. However, we do attempt to reduce such risks by generally limiting the maturity date of such securities, diversifying our investments and limiting the amount of credit exposure with any one issuer. While we do not always have the intent, we do currently have the ability to hold these investments until maturity and, therefore, believe that reductions in the value of such securities attributable to short-term fluctuations in interest rates would not materially affect our financial position, results of operations or cash flows. Changes in interest rates would, of course, affect the interest income we earn on our cash balances after re-investment.

Foreign Currency Exchange Rate Exposure

Our exposure to market risk due to fluctuations in foreign currency exchange rates relates primarily to our cash balances in Europe and Japan. Transaction gains or losses resulting from cash balances and revenues have not been significant in the past and we are not engaged in any hedging activity in the Euro, the Yen or other currencies. Based on our cash balances and revenues derived from markets other than the United States for the quarter ended September 30, 2006, a hypothetical 10% adverse change in the Euro or Yen against the U.S. dollar would not result in a material foreign currency exchange loss. Consequently, we do not expect that reductions in the value of such sales denominated in foreign currencies resulting from even a sudden or significant fluctuation in foreign exchange rates would have a direct material impact on our financial position, results of operations or cash flows.

Notwithstanding the foregoing, the indirect effect of fluctuations in interest rates and foreign currency exchange rates could have a material adverse effect on our business, financial condition and results of operations. For example, foreign currency exchange rate fluctuations may affect international demand for our products. In addition, interest rate fluctuations may affect our customers' buying patterns. Furthermore, interest rate and currency exchange rate fluctuations may broadly influence the United States and foreign economies resulting in a material adverse effect on our business, financial condition and results of operations.

Under our Japanese Thin Film agreement with Senko, we would receive payments in the nature of royalties based on Senko's net sales, which would be Yen denominated. We expect such sales or royalties to begin early 2007.

Item 4. Controls and Procedures

Christopher J. Calhoun, our Chief Executive Officer, and Mark E. Saad, our Chief Financial Officer, after evaluating the effectiveness of our "disclosure controls and procedures" (as defined in Securities Exchange Act Rule 13a-15(e)), have concluded that as of September 30, 2006, our disclosure controls and procedures are effective.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

From time to time, we have been involved in routine litigation incidental to the conduct of our business. As of September 30, 2006, we were not a party to any material legal proceeding. We are not formally a party to the University of Pittsburgh patent litigation. However, we are responsible for reimbursing certain related litigation costs.

Item 1A. Risk Factors

In analyzing our company, you should consider carefully the following risk factors, together with all of the other information included in this quarterly report on Form 10-Q. Factors that could adversely affect our business, operating results and financial condition, as well as adversely affect the value of an investment in our common stock, include those discussed below, as well as those discussed above in "Management's Discussion and Analysis of Financial Condition and Results of Operations" and elsewhere throughout this quarterly report on Form 10-Q.

We are subject to the following significant risks, among others:

We will need to raise more cash in the future

As of September 30, 2006, we had $18,449,000 of cash, cash equivalents and short-term investments; we have always had negative cash flows from operations. Our regenerative cell business will continue to result in a substantial requirement for research and development expenses for several years, during which it could bring in no significant revenues. Our spine and orthopedics products business is doing poorly and is losing money. There can be no guarantee that adequate funds for our operations from any additional debt or equity financing, our operating revenues, arrangements with distribution partners or from other sources will be available when needed or on terms attractive to us. The inability to obtain sufficient funds would require us to delay, scale back or eliminate some or all of our research or product development programs, manufacturing operations, clinical studies or regulatory activities or to license third parties to commercialize products or technologies that we would otherwise seek to develop ourselves, thus having a substantial negative effect on the results of our operations and financial condition.

We have never been profitable on an operational basis and we will have significant operating losses for at least the next several years

We have incurred net operating losses in each year since we started doing business. These losses have resulted primarily from expenses associated with our research and development activities and general and administrative expenses. Development-stage losses related to our development of regenerative cell technology are expected to keep us in a loss position on a consolidated basis for several years. We anticipate that our recurring operating expenses will be at high levels for the next several years, due to the continued need to fund our clinical research program as well as additional preclinical research. We expect to continue to incur operational losses in our spine and orthopedics business at least through the end of 2006, and the amount of future net losses and time necessary to reach operational profitability in that business are somewhat uncertain.

Our business is high-risk

We are focusing our resources and efforts primarily on our regenerative cell technology and its development-stage cash needs. This is a high-risk strategy because there can be no assurance that our regenerative cell technology will ever be developed into commercially viable products (commercial risk), that we will be able to preclude other companies from depriving us of market share and profit margins by selling products based on our inventions and developments (legal risk), that we will be able to successfully manage a company in a different business than we have operated in the past (operational risk), that we will be able to deliver regenerative cells into the body to achieve the desired therapeutic results (scientific risk), or that our cash resources will be adequate to develop the regenerative cell technology until it becomes profitable, if ever (financial risk). We are using our cash in one of the riskiest industries in the economy (strategic risk). This may make our stock an unsuitable investment for some investors.

The financial risk in this strategy is significant, particularly since our bioresorbable products are not currently independently cash-flow-positive. Although we eliminated the negative cash flow of the early commercialization stage of the (non-Japan) Thin Film business by selling that business to MAST in May 2004, even our core spine and orthopedics implants business fell back into a negative cash flow position in 2004 due to the sharp reduction in orders from and sales to Medtronic. This trend continued in 2005 despite stocking orders for the new MYSTIQUE™ line and since then the orders and sales have again declined sharply.

We must keep our joint venture with Olympus operating smoothly

Our regenerative cell business cannot succeed on the current timelines unless our joint venture collaboration with Olympus goes well. We have given Olympus-Cytori, Inc. an exclusive license to our regenerative cell therapeutic device technology for use in future generation devices. If Olympus-Cytori, Inc. does not successfully develop and manufacture future generation devices for sale to us, we may not be able to commercialize any device or any therapeutic products successfully into the market. In addition, any future disruption in or breakup of our relationship with Olympus would be extremely costly to our reputation, in addition to causing many serious practical problems.

We and Olympus must overcome contractual and cultural barriers as we work together. Our relationship is formally measured by a set of complex contracts, which have not yet been tested in practice. In addition, many aspects of the relationship will be essentially non-contractual and must be worked out between the parties and the responsible individuals over time. The Joint Venture is intended to have a long life, and it is difficult to maintain cooperative relationships over a long period of time from a far distance in the face of various kinds of change. Cultural differences, including a language barrier to some degree, may affect the efficiency of the relationship as well.

Olympus-Cytori, Inc. is 50% owned by us and 50% owned by Olympus. By contract, each side must consent before any of a wide variety of important business actions can occur. This situation possesses a risk of potential time-consuming and difficult negotiations which could at some point delay the Joint Venture from pursuing its business strategies.

Olympus is entitled to designate the Joint Venture's chief executive officer and a majority of its board of directors, which means that day-to-day decisions which are not subject to a contractual veto will essentially be controlled by Olympus. In addition, Olympus-Cytori, Inc. will need more money than its initial capitalization in order to finalize development of and production of the future generation devices. If we are unable to help provide future financing for Olympus-Cytori, Inc., our relative equity interest in Olympus-Cytori, Inc. may decrease.

Furthermore, under a License/Joint Development Agreement among Olympus-Cytori, Inc., Olympus, and us, Olympus will have a primary role in the development of Olympus-Cytori, Inc.'s future generation devices. Although Olympus has extensive experience in developing medical devices, this arrangement will result in a reduction of our control over the development and manufacturing of the future generation devices.

We rely on Medtronic to distribute a majority of our current biomaterials products, but Medtronic's level of commitment to our products is doubtful

We have limited control over sales, marketing and distribution of our biomaterials products. Our strategy for sales and marketing of our bioresorbable products included entering into an agreement with Medtronic, a company with a large distribution network, to market many of our current and certain future products incorporating our technology. The sale of hard-tissue-fixation bioresorbable implant products to our distribution partner, Medtronic, has constituted the majority of our revenues.

We remain significantly dependent on Medtronic to generate sales revenues for all of our spine and orthopedics bioresorbable products. The amount and timing of resources which may be devoted to the performance of Medtronic's contractual responsibilities are not within our control. There can be no guarantee that Medtronic will perform its obligations as expected or pay us any additional option or license fees. There is also no guarantee that it will market any new products under the distribution agreements or that we will derive any significant revenue from such arrangements. Medtronic's sale of our products to end customers in 2004 and 2005 and the first nine months of 2006, and its rate of product orders placed with us in the same periods, disappointed our expectations with the exception of 2005 stocking orders for the new MYSTIQUE™ line. 2004 and 2005 results and the first nine months of 2006 were exceptionally weak, and we are significantly disappointed with the marketing efforts of Medtronic for our non-MYSTIQUE™ products at this time. We recorded an inventory provision for slow-moving non-MYSTIQUE™ inventory in the second, third and fourth quarters of 2005. We are also becoming concerned about Medtronic's commitment to MYSTIQUE™.

Our dependence upon Medtronic to market and sell our bioresorbable products places us in a position where we cannot accurately predict the extent to which our products will be actively and effectively marketed, depriving us of some of the reliable data we need to make optimal operational and strategic decisions. The consequent lack of visibility is evidenced by the withdrawal of our announced financial guidance for 2004, and our results falling within the lowest range of our guidance for 2005. The results of this business line so far in 2006 have been below our internal expectations.

The prices which Medtronic pays us are fixed (pending biannual price reviews in January and July of each year), based on a percentage of Medtronic's historic selling price to its customers. If our costs increase but our selling prices remain fixed, our profit margin will suffer.

Medtronic owns 5.38% of our stock, which may limit our ability to negotiate commercial arrangements optimally with Medtronic. Although Medtronic has exclusive distribution rights to our co-developed spinal implants, it also distributes other products that are competitive to ours. Medtronic might choose to develop and distribute existing or alternative technologies in preference to our technology in the spine, or preferentially market competitive products that can achieve higher profit margins. We suspect that this has in fact been happening.

There can be no assurance that our interests will coincide with those of Medtronic or that disagreement over rights or technology or other proprietary interests will not occur. The loss of the marketing services provided by Medtronic (or the failure of Medtronic to satisfactorily perform these marketing services), or the loss of revenues generated by Medtronic, could have a substantial negative effect on our ability or willingness to continue our spine and orthopedics biomaterials business. Indeed, even with Medtronic in place it seems the problems we have experienced may be intractable, and we are considering the possibility that the business cannot succeed under our stewardship. Accordingly, we are considering the possibility of divestment or other strategic alternatives for the business.

Senko has not yet begun to distribute our Thin Film products in Japan; but if and when they do, we cannot be assured that they will be successful.

We have a limited operating history; our operating results can be volatile

Our prospects must be evaluated in light of the risks and difficulties frequently encountered by emerging companies and particularly by such companies in rapidly evolving and technologically advanced fields such as the biotechnology and medical device fields. Due to our limited operating history, and the development stage status of our regenerative cell business, comparisons of our year-to-year operating results are not necessarily meaningful and the results for any periods should not necessarily be relied upon as an indication for future performance. Since our limited operating history makes the prediction of future results difficult or impossible, our recent revenue results should not be taken as an indication of any future growth or of a sustainable level of revenue. Operating results will also be affected by our transition away from our revenue generating medical device business and the focus of the vast majority of our resources into the development-stage regenerative cell business.

Moreover, our operating results can vary substantially from our previously published financial guidance (such as occurred in the second quarter of 2004), from analyst expectations and from previous periodic results for many reasons, including the timing of product introductions and distributor purchase orders. Also, the 2002 sale of our CMF bone fixation implant and accessory product line, which had represented a large portion of our revenues, plus the 2004 sale of our (non-Japan) Thin Film surgical implants for separation of soft tissues, have distorted and will distort quarterly and annual earning comparisons through 2004, 2005 and 2006. Earnings surprises can have a disproportionate effect on the stock prices of emerging companies such as ours. Also, our stock price is likely to be disproportionately affected by changes which generally affect the economy, the stock market or the medical device and biotechnology industries.

From time to time, we have tried to influence our investors' expectations as to our operating results by periodically announcing financial guidance. However, we have in the past been forced to revise or withdraw such guidance due to lack of visibility and predictability of product demand. This lack of visibility and predictability of product demand for our bioresorbable implant products is likely to occur in the future as well.

We are vulnerable to competition and technological change, and also to physicians' inertia

We compete with many domestic and foreign companies in developing our technology and products, including biotechnical, medical device, pharmaceutical and biopharmaceutical companies. Many of our competitors and potential competitors have substantially greater financial, technological, research and development, marketing and personnel resources than we do. There can be no assurance that our competitors will not succeed in developing alternative technologies and products that are more effective, easier to use or more economical than those which we have developed or are in the process of developing or that would render our technology and products obsolete and non-competitive in these fields. In general, we may not be able to preclude other companies from developing and marketing competitive regenerative cell therapies or bioresorbable products that are similar to ours or perform similar functions.

These competitors may also have greater experience in developing therapeutic treatments, conducting clinical trials, obtaining regulatory clearances or approvals, manufacturing and commercializing therapeutic or biomaterials products. It is possible that certain of these competitors may obtain patent protection, approval or clearance by the U.S. Food and Drug Administration "FDA" or achieve commercialization earlier than we, any of which could have a substantial negative effect on our business. Finally, Olympus, Medtronic and our other partners might pursue parallel development of other technologies or products, which may result in a partner developing additional products that will compete with our products.

We also compete with other types of regenerative cell therapies such as bone marrow derived cell therapies, and potentially embryonic derived therapies. Our biomaterials business competes with manufacturers of traditional non-bioresorbable implants, such as titanium implants. Doctors have historically been slow to adopt new technologies such as ours, whatever the merits, when older technologies continue to be supported by established providers. Overcoming such inertia often requires very significant marketing expenditures or definitive product superiority.

We expect physicians' inertia and skepticism to also be a significant barrier as we attempt to gain market penetration with our future regenerative cell products. We believe we will need to finance lengthy time-consuming clinical studies (so as to provide convincing evidence of the medical benefit) in order to overcome this inertia and skepticism.

Our regenerative cell technology products are pre-commercialization, which subjects us to development and marketing risks

We are in a relatively early stage of the path to commercialization with many of our products. We believe that our long-term viability and growth will depend in large part on our ability to develop commercial quality cell processing devices and to establish the safety and efficacy of our therapies through clinical trials and studies. We are presently pursuing regenerative cell opportunities in cardiovascular disease, spine and orthopedic conditions, gastrointestinal disorders and new approaches for aesthetic and reconstructive surgery that may require extensive additional capital investment, research, development, clinical testing and regulatory clearances or approvals prior to commercialization. There can be no assurance that our development programs will be successfully completed or that required regulatory clearances or approvals will be obtained on a timely basis, if at all.

The path to commercial profit from our regenerative cell technology is unclear even if we demonstrate the medical benefit of our regenerative cell technology in various applications. There is no proven path for commercializing the technology in a way to earn a durable profit commensurate with the medical benefit. Although we intend to develop proprietary therapeutic products which optimize or enhance the benefit of autologous stem cells for particular indications, we have no yet actually developed any such products. Most of our cell-related products and/or services (as opposed to our Celution™ device) are at least three to five years away.

Moreover, the successful development and market acceptance of our technologies and products are subject to inherent developmental risks, including failure of inventive imagination, ineffectiveness or lack of safety, unreliability, failure to receive necessary regulatory clearances or approvals, high commercial cost and preclusion or obsolescence resulting from third parties' proprietary rights or superior or equivalent products, as well as general economic conditions affecting purchasing patterns. There can be no assurance that we or our partners will be able to successfully develop and commercialize our technologies or products, or that our competitors will not develop competing technologies that are less expensive or otherwise superior to ours. The failure to successfully develop and market our new regenerative cell technologies would have a substantial negative effect on the results of our operations and financial condition.

We have limited manufacturing experience

We have no experience in manufacturing the Celution™ system at a commercial level, and although Olympus is a highly capable and experienced manufacturer of medical devices, there can be no guarantee that the Olympus-Cytori joint venture will be able to successfully develop and manufacture the Celution™ system in a manner that is cost-effective or commercially viable, or that development and manufacturing capabilities might not take much longer than currently anticipated to be ready for the market.

In the event that the Olympus-Cytori joint venture is not successful, Cytori may not have the required level of technical ability or other resources to self manufacture commercially viable devices, and in any event this failure would substantially extend the time it would take for us to bring a commercial device to market. This makes us significantly dependant on the continued dedication and skill of Olympus for the successful development of the Celution™ system.

In addition, we have no experience in manufacturing the type of cell-related therapeutic products which we hope to develop and introduce in the future.

In addition, the future of our biomaterials business success is significantly dependent on our ability to manufacture our bioresorbable implants in commercial quantities, in compliance with regulatory requirements and in a cost-effective manner. Production of some of our products in commercial-scale quantities may involve unforeseen technical challenges and may require significant scale-up expenses for additions to facilities and personnel. There can be no guarantee that we will be able to achieve large-scale manufacturing capabilities for some of our biomaterials products or that we will be able to manufacture these products in a cost-effective manner or in quantities necessary to allow us to achieve profitability. Our 2002 sale of CMF production assets to Medtronic and our 2004 sale of the (non-Japan) Thin Film product line deprived us of some economies of scale in manufacturing. Current demand for spine and orthopedics products from Medtronic is so low that economies of scale are lacking in regard to that product line as well.

If we are unable to sufficiently meet Medtronic's requirements for certain products as set forth under its agreement, Medtronic itself may then manufacture and sell such product and only pay us royalties on the sales. The resulting loss of payments from Medtronic for the purchase of these products may have a substantial negative effect on the results of our operations and financial condition.

We have to maintain quality assurance certification and manufacturing approvals

The manufacture of our bioresorbable products is, and the manufacture of the Celution™ system for regenerative cells will be, and the manufacture of any future cell-related therapeutic products would be, subject to periodic inspection by regulatory authorities and distribution partners. The manufacture of devices and products for human use is subject to regulation and inspection from time to time by the FDA for compliance with the FDA's Quality System Regulation "QSR" requirements, as well as equivalent requirements and inspections by state and non-U.S. regulatory authorities. There can be no guarantee that the FDA or other authorities will not, during the course of an inspection of existing or new facilities, identify what they consider to be deficiencies in our compliance with QSRs or other requirements and request, or seek, remedial action.

Failure to comply with such regulations or a potential delay in attaining compliance may adversely affect our manufacturing activities and could result in, among other things, injunctions, civil penalties, FDA refusal to grant pre-market approvals or clearances of future or pending product submissions, fines, recalls or seizures of products, total or partial suspensions of production and criminal prosecution. There can be no assurance that we will be able to obtain additional necessary regulatory approvals or clearances on a timely basis, if at all. Delays in receipt of or failure to receive such approvals or clearances or the loss of previously received approvals or clearances could have a substantial negative effect on the results of our operations and financial condition.

We depend on a sole source supplier for our crucial raw material for our bioresorbable products

We currently purchase the high molecular weight, medical grade, lactic acid copolymer used in manufacturing most of our bioresorbable products, from a single qualified source. Although we have a contract with B.I. Chemicals, Inc., which guarantees continuation of supply through August 15, 2007, we cannot guarantee that they will elect to continue the contract beyond that date, or that they will not elect to discontinue the manufacture of the material. They have agreed that if they discontinue manufacturing they will either find a replacement supplier, or provide us with the necessary technology to self-manufacture the material, either of which could mean a substantial increase in material costs. Also, despite this agreement they might fail to do these things for us. Under the terms of the contract, B.I. Chemicals, Inc. may choose to raise their prices upon nine months' prior notice which may also result in a substantially increased material cost. Although we believe that we would be able to obtain the material from at least one other source in the event of a failure of supply, there can be no assurance that we will be able to obtain adequate increased commercial quantities of the necessary high quality within a reasonable period of time or at commercially reasonable rates. Lack of adequate commercial quantities or the inability to develop alternative sources meeting regulatory requirements at similar prices and terms within a reasonable time or any interruptions in supply in the future could have a significant negative effect on our ability to manufacture products, and, consequently, could have a material adverse effect on the results of our operations and financial condition.

We may not be able to protect our proprietary rights

Our success depends in part on whether we can obtain additional patents, maintain trade secret protection and operate without infringing on the proprietary rights of third parties.

Our recently amended regenerative cell technology license agreement with the Regents of the University of California contains certain developmental milestones, which if not achieved could result in the loss of exclusivity or loss of the license rights. The loss of such rights could significantly impact our ability to develop certain regenerative cell technology and commercialize related products. Also, our power as licensee to successfully use these rights to exclude competitors from the market is untested. In addition, further legal risk arises from a lawsuit, filed by the University of Pittsburgh naming all of the inventors who had not assigned their ownership interest in Patent 6,777,231 to the University of Pittsburgh, seeking a determination that its assignors, rather than the University of California's assignors, are the true inventors of Patent 6,777,231. We are the exclusive, worldwide licensee of the University of California's rights under this patent, which relates to adult stem cells isolated from adipose tissue that can differentiate into two or more of a variety of cell types. If the University of Pittsburgh wins the lawsuit, our license rights to this patent could be nullified or rendered non-exclusive with respect to any third party that might license rights from the University of Pittsburgh, and our regenerative cell strategy could be impacted.

We have various U.S. patents for the design of our bioresorbable plates and high torque screws and devices and we have filed applications for numerous additional U.S. patents, as well as certain corresponding patent applications outside the United States, relating to our technology. However, we believe we cannot patent the use of our lactic acid copolymer for surgical implants, nor are many of our particular implants generally patentable.

There can be no assurance that any of the pending patent applications will be approved or that we will develop additional proprietary products that are patentable. There is also no assurance that any patents issued to us will provide us with competitive advantages, will not be challenged by any third parties or that the patents of others will not prevent the commercialization of products incorporating our technology. Furthermore, there can be no guarantee that others will not independently develop similar products, duplicate any of our products or design around our patents.

Our commercial success will also depend, in part, on our ability to avoid infringing on patents issued to others. If we were judicially determined to be infringing on any third party patent, we could be required to pay damages, alter our products or processes, obtain licenses or cease certain activities. If we are required in the future to obtain any licenses from third parties for some of our products, there can be no guarantee that we would be able to do so on commercially favorable terms, if at all. U.S. patent applications are not immediately made public, so we might be surprised by the grant to someone else of a patent on a technology we are actively using. As noted above as to U Pitt lawsuit, even patents issued to us or our licensors might be judicially determined to belong in full or in part to third parties.

Litigation, which would result in substantial costs to us and diversion of effort on our part, may be necessary to enforce or confirm the ownership of any patents issued or licensed to us or to determine the scope and validity of third party proprietary rights. If our competitors claim technology also claimed by us and prepare and file patent applications in the United States, we may have to participate in interference proceedings declared by the U.S. Patent and Trademark Office or a foreign patent office to determine priority of invention, which could result in substantial costs to and diversion of effort, even if the eventual outcome is favorable to us.

Any such litigation or interference proceeding, regardless of outcome, could be expensive and time consuming. We have been incurring substantial legal costs as a result of the University of Pittsburgh lawsuit, and our president, Marc Hedrick, is a named individual defendant in that lawsuit because he is one of the inventors identified on the patent. As a named inventor on the patent, Marc Hedrick is entitled to receive from the Regents of the University of California up to 7% of royalty payments made by a license (us) to the Regents of the University of California. This agreement was in place prior to his employment with us.

In addition to patents, which alone may not be able to protect the fundamentals of our regenerative cell and bioresorbable businesses, we also rely on unpatented trade secrets and proprietary technological expertise. We rely, in part, on confidentiality agreements with our partners, employees, advisors, vendors and consultants to protect our trade secrets and proprietary technological expertise. There can be no guarantee that these agreements will not be breached, or that we will have adequate remedies for any breach, or that our unpatented trade secrets and proprietary technological expertise will not otherwise become known or be independently discovered by competitors.

Failure to obtain or maintain patent protection, or protect trade secrets, for any reason (or third party claims against our patents, trade secrets or proprietary rights, or our involvement in disputes over our patents, trade secrets or proprietary rights, including involvement in litigation), could have a substantial negative effect on the results of our operations and financial condition.

We may not be able to protect our intellectual property in countries outside the United States

Intellectual property law outside the United States is uncertain and in many countries is currently undergoing review and revisions. The laws of some countries do not protect our patent and other intellectual property rights to the same extent as United States laws. We currently have pending patent applications in Europe, Australia, Japan, Canada, China, Korea, and Singapore, among others.

We are, and Olympus-Cytori, Inc. will be, subject to intensive FDA regulation

As newly developed medical devices, our and Olympus-Cytori's regenerative cell harvesting, isolation and delivery devices and our bioresorbable implants must receive regulatory clearances or approvals from the FDA and, in many instances, from non-U.S. and state governments, prior to their sale. Our and Olympus-Cytori's current and future regenerative cell harvesting, isolation and delivery devices and bioresorbable implants are subject to stringent government regulation in the United States by the FDA under the Federal Food, Drug and Cosmetic Act. The FDA regulates the design/development process, clinical testing, manufacture, safety, labeling, sale, distribution and promotion of medical devices and drugs. Included among these regulations are pre-market clearance and pre-market approval requirements, design control requirements, and the Quality System Regulations / Good Manufacturing Practices. Other statutory and regulatory requirements govern, among other things, establishment registration and inspection, medical device listing, prohibitions against misbranding and adulteration, labeling and post market reporting.

The regulatory process can be lengthy, expensive and uncertain. Before any new medical device may be introduced to the United States market, the manufacturer generally must obtain FDA clearance or approval through either the 510(k) pre-market notification process or the lengthier pre-market approval application "PMA" process. It generally takes from three to 12 months from submission to obtain 510(k) pre-market clearance, although it may take longer. Approval of a PMA could take four or more years from the time the process is initiated. The 510(k) and PMA processes can be expensive, uncertain and lengthy, and there is no guarantee of ultimate clearance or approval. We expect that some of our future products under development as well as Olympus-Cytori's will be subject to the lengthier PMA process. Securing FDA clearances and approvals may require the submission of extensive clinical data and supporting information to the FDA, and there can be no guarantee of ultimate clearance or approval. Failure to comply with applicable requirements can result in application integrity proceedings, fines, recalls or seizures of products, injunctions, civil penalties, total or partial suspensions of production, withdrawals of existing product approvals or clearances, refusals to approve or clear new applications or notifications and criminal prosecution.

Medical devices are also subject to post-market reporting requirements for deaths or serious injuries when the device may have caused or contributed to the death or serious injury, and for certain device malfunctions that would be likely to cause or contribute to a death or serious injury if the malfunction were to recur. If safety or effectiveness problems occur after the product reaches the market, the FDA may take steps to prevent or limit further marketing of the product. Additionally, the FDA actively enforces regulations prohibiting marketing and promotion of devices for indications or uses that have not been cleared or approved by the FDA.

Our current medical implants are at different stages of FDA review. We currently have 510(k) clearances for a wide variety of bioresorbable surgical implant products and we are constantly engaged in the process of obtaining additional clearances for new and existing products. There can be no guarantee that we will be able to obtain the necessary 510(k) clearances or PMA approvals to market and manufacture our other products in the United States for their intended use on a timely basis, if at all. Delays in receipt of or failure to receive such clearances or approvals, the loss of previously received clearances or approvals, or failure to comply with existing or future regulatory requirements could have a substantial negative effect on the results of our operations and financial condition.

To sell in international markets, we will be subject to intensive regulation in foreign countries

In cooperation with our distribution partners, we intend to market our current and future products both domestically and in many foreign markets. A number of risks are inherent in international transactions. In order for us to market our products in Europe, Canada, Japan and certain other non-U.S. jurisdictions, we need to obtain and maintain required regulatory approvals or clearances and must comply with extensive regulations regarding safety, manufacturing processes and quality. For example, we still have not obtained regulatory approval for our Thin Film products in Japan. These regulations, including the requirements for approvals or clearances to market, may differ from the FDA regulatory scheme. International sales also may be limited or disrupted by political instability, price controls, trade restrictions and changes in tariffs. Additionally, fluctuations in currency exchange rates may adversely affect demand for our products by increasing the price of our products in the currency of the countries in which the products are sold.

There can be no assurance that we will obtain regulatory approvals or clearances in all of the countries where we intend to market our products, or that we will not incur significant costs in obtaining or maintaining foreign regulatory approvals or clearances, or that we will be able to successfully commercialize current or future products in various foreign markets. Delays in receipt of approvals or clearances to market our products in foreign countries, failure to receive such approvals or clearances or the future loss of previously received approvals or clearances could have a substantial negative effect on the results of our operations and financial condition.

We depend on a few key officers

Our performance is substantially dependent on the performance of our executive officers and other key scientific staff, including Christopher J. Calhoun, our Chief Executive Officer, and Marc Hedrick, MD, our President. We rely upon them for strategic business decisions and guidance. We believe that our future success in developing marketable products and achieving a competitive position will depend in large part upon whether we can attract and retain additional qualified management and scientific personnel. Competition for such personnel is intense, and there can be no assurance that we will be able to continue to attract and retain such personnel. The loss of the services of one or more of our executive officers or key scientific staff or the inability to attract and retain additional personnel and develop expertise as needed could have a substantial negative effect on our results of operations and financial condition. Three executive officers have left us in 2006, two in connection with a summer 2006 reduction of our headcount by 18%.

Companies which make personnel cuts sometimes find the resulting loss of experience and lack of coverage can cause important business problems.

We may not have enough product liability insurance

The testing, manufacturing, marketing and sale of our regenerative cell and bioresorbable implant products involve an inherent risk that product liability claims will be asserted against us, our distribution partners or licensees. There can be no guarantee that our clinical trial and commercial product liability insurance is adequate or will continue to be available in sufficient amounts or at an acceptable cost, if at all. A product liability claim, product recall or other claim, as well as any claims for uninsured liabilities or in excess of insured liabilities, could have a substantial negative effect on the results of our operations and financial condition. Also, well-publicized claims could cause our stock to fall sharply, even before the merits of the claims are decided by a court.

Our charter documents contain anti-takeover provisions and we have adopted a Stockholder Rights Plan to prevent hostile takeovers

Our Amended and Restated Certificate of Incorporation and Bylaws contain certain provisions that could prevent or delay the acquisition of the Company by means of a tender offer, proxy contest or otherwise. They could discourage a third party from attempting to acquire control of the Company, even if such events would be beneficial to the interests of our stockholders. Such provisions may have the effect of delaying, deferring or preventing a change of control of the Company and consequently could adversely affect the market price of our shares. Also, in 2003 we adopted a Stockholder Rights Plan, of the kind often referred to as a poison pill. The purpose of the Stockholder Rights Plan is to prevent coercive takeover tactics that may otherwise be utilized in takeover attempts. The existence of such a rights plan may also prevent or delay a change in control of the Company, and this prevention or delay adversely affect the market price of our shares.

We pay no dividends

We currently do not intend to pay any cash dividends for the foreseeable future.

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

We held our annual meeting of stockholders on August 10, 2006. Of the 15,614,170 shares of our common stock which could be voted at the annual meeting, 10,565,814 shares of our common stock were represented at the annual meeting in person or by proxy, which constituted a quorum. Voting results were as follows:

a. Election of the following persons to our Board of Directors to hold office until the next annual meeting of stockholders:

	For	Withheld
Christopher J. Calhoun	10,565,017	797
Marshall G. Cox	10,565,204	610
Paul W. Hawran	10,565,304	510
Marc H. Hedrick, MD	10,565,304	510
Ronald D. Henriksen	10,565,304	510
E. Carmack Holmes, MD	10,565,304	510
David M. Rickey	10,565,304	510

b. The proposal to ratify the selection of KPMG LLP as the Company's independent registered public accounting firm for the fiscal year ending December 31, 2006, received the following votes:

For	Against	Abstain
10,565,007	620	187

Item 5.

Other Information

Material Agreements

None

Property

On May 24, 2005, we entered into a lease for 91,000 square feet located at 3020 and 3030 Callan Road, San Diego, California. We moved the majority of our operations to this new facility during the second half of 2005 and the first quarter of 2006. The agreement bears rent at a rate of $1.15 per square foot, with annual increases of 3%. The lease term is 57 months, commencing on October 1, 2005 and expiring on June 30, 2010.

We also have a facility located at 6740 Top Gun Street, San Diego, California. We currently lease approximately 27,000 square feet of space at this location of which approximately 6,000 square feet is laboratory space, 12,000 square feet is office space and 9,000 square feet is manufacturing space. Our lease has a five-year term, expiring in 2008. We also lease:

- 16,000 additional square feet for research and development activities located at 6749 Top Gun Street, San Diego, California for a five-year term expiring 2008.

- 4,027 square feet of office space located at 9-3 Otsuka 2-chome, Bunkyo-ku, Tokyo, Japan. The agreement bears rent at a rate of $3.66 per square foot, for a term of two years expiring on November 30, 2007.

On the properties stated above, we pay an aggregate of approximately $198,000 in rent per month.

Staff

As of September 30, 2006, we had 121 full-time equivalent employees, comprised of 5 employees in manufacturing, 79 employees in research and development, 4 employees in sales and marketing and 33 employees in management and finance and administration. From time to time, we also employ independent contractors to support our administrative organizations. Our employees are not represented by any collective bargaining unit and we have never experienced a work stoppage. A breakout by segment is as follows:

	Regenerative Cell Technology	MacroPore Biosurgery	Corporate	Total
Manufacturing	—	5	—	5
Research & Development	78	1	—	79
Sales and Marketing	4	—	—	4
General & Administrative	—	—	33	33
Total	82	6	33	121

Item 6. Exhibits

10.32	Common Stock Purchase Agreement, dated August 9, 2006, by and between Cytori Therapeutics, Inc. and Olympus Corporation (filed as Exhibit 10.32 to our Form 8-K Current Report as filed on August 15, 2006 and incorporated by reference herein)
10.33	Form of Common Stock Subscription Agreement, dated August 9, 2006 (Agreements on this form were signed by Cytori and each of respective investors in the Institutional Offering) (filed as Exhibit 10.33 to our Form 8-K Current Report as filed on August 15, 2006 and incorporated by reference herein)
10.34	Placement Agency Agreement, dated August 9, 2006, between Cytori Therapeutics, Inc. and Piper Jaffray & Co. (filed as Exhibit 10.34 to our Form 8-K Current Report as filed on August 15, 2006 and incorporated by reference herein)
10.35 #	Stock Option Extension Agreement between Bruce A. Reuter and Cytori Therapeutics, Inc. effective July 25, 2006
10.36 #	Stock Option Extension Agreement between Elizabeth A. Scarbrough and Cytori Therapeutics, Inc. effective July 25, 2006
10.37 #	Employment Agreement between Bruce A. Reuter and Cytori Therapeutics, Inc. effective July 25, 2006
10.38 #	Employment Agreement between Elizabeth A. Scarbrough and Cytori Therapeutics, Inc. effective July 25, 2006
10.39 +	Amended and Restated Exclusive License Agreement, effective September 26, 2006, by and between The Regents of the University of California and Cytori Therapeutics, Inc.
15.1	Letter re unaudited interim financial information
31.1	Certification of Chief Executive Officer Pursuant to Securities Exchange Act Rule 13a-14(a) As Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer Pursuant to Securities Exchange Act Rule 13a-14(a) As Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification pursuant to 18 U.S.C. Section 1350/ Securities Exchange Act Rule 13a-14(b), As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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+ Portions of these exhibits have been omitted pursuant to a request for confidential treatment.

# Indicates management contract or compensatory plan or arrangement.

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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, in San Diego, California, on November 14, 2006.

CYTORI THERAPEUTICS, INC.

Dated: November 14, 2006

By: /s/ Christopher J. Calhoun
Christopher J. Calhoun
Chief Executive Officer

Dated: November 14, 2006

By: /s/ Mark E. Saad
Mark E. Saad
Chief Financial Officer

EXHIBIT 10.35

STOCK OPTION EXTENSION AGREEMENT

This Stock Option Extension Agreement ("Agreement") is entered into as of July 25, 2006 (the "Effective Date"), by and between Cytori Therapeutics, Inc., a Delaware corporation located at 3020 Callan Road, San Diego, CA 92121 (the "Company"), and Bruce A. Reuter, an employee of the Company (the "Optionee").

WHEREAS, as of July 25, 2006 Optionee holds a combined total of 224,686 vested stock options to purchase shares of the Company's common stock under the Company's 1997 Incentive Stock Option Plan (the "1997 Plan") and/or the Company's 2004 Employee Stock Option Plan (the "2004 Plan") (collectively the "Plans"); and

WHEREAS, Company agrees to modify the Plan agreements to extend the expiration dates for the exercise of stock options under the Plans subject to certain restrictions and conditions on the sale of shares of the Company's common stock held by Optionee, and certain other consideration from the Optionee.

NOW, THEREFORE, the Company and the Optionee agree as follows:

(a) The right of the Optionee to exercise Two Hundred and Twenty Four Thousand, Six Hundred and Eighty Six (224,686) fully vested Plan stock options (which consists of all of Optionee's vested stock Options as of the Effective Date) is hereby extended to December 31, 2007, irrespective of the date that Optionee's services to the Company terminate.

(b) The exercise extension provided for in Section (a) above is subject to the following conditions and restrictions:

(i) Immediately upon termination of Optionee's employment as provided for in the Employment Agreement between the Company and Optionee, Optionee shall execute and sign a full release of all claims against the Company in the form attached as Exhibit I, which is that Company's standard employment related release of claims.

(ii) No shares of common stock of the Company owned by Optionee may be sold by or on behalf of Optionee during the initial 90-day period from July 25, 2006 through October 23, 2006; (b) Optionee may sell up to 56,173 shares of common stock owned by him beginning October 24, 2006; (c) and Optionee may sell an additional 56,171 beginning on January 21, 2007 and each ninety days thereafter until July 20, 2007 when 100% of Optionee's shares of common stock in the Company shall be fully tradable. The trade restrictions listed above shall be eliminated once the per-share trading price of the Company's common stock on the Nasdaq exchange closes at or above $13 per share, or if the 30 day average daily stock volume reaches 50,000 shares.

(c) All stock options previously granted to Optionee that are not vested as of the Effective Date of this Agreement are hereby terminated as of the Effective Date.

(d) Except as specifically set forth herein, all other terms and conditions of the Plans and the Plan Agreements shall remain in full force and effect.

IN WITNESS WHEREOF, this Agreement has been executed and delivered by the parties on the Effective Date.

OPTIONEE:	COMPANY:
Bruce A. Reuter	Cytori Therapeutics, Inc.
/s/ Bruce A. Reuter	By: /s/ Christopher J. Calhoun Name: Christopher J. Calhoun Title: Chief Executive Officer

Exhibit 10.36

STOCK OPTION EXTENSION AGREEMENT

This Stock Option Extension Agreement ("Agreement") is entered into as of July 25, 2006 (the "Effective Date"), by and between Cytori Therapeutics, Inc., a Delaware corporation located at 3020 Callan Road, San Diego, CA 92121 (the "Company"), and Elizabeth A. Scarbrough, an employee of the Company (the "Optionee").

WHEREAS, as of July 25, 2006 Optionee holds a combined total of 103,878 vested stock options to purchase shares of the Company's common stock under the Company's 1997 Incentive Stock Option Plan (the "1997 Plan") and/or the Company's 2004 Employee Stock Option Plan (the "2004 Plan") (collectively the "Plans"); and

WHEREAS, Company agrees to modify the Plan agreements to extend the expiration dates for the exercise of stock options under the Plans subject to certain restrictions and conditions on the sale of shares of the Company's common stock held by Optionee, and Optionees agreement to execute a release of claims.

NOW, THEREFORE, the Company and the Optionee agree as follows:

(a) The right of the Optionee to exercise One Hundred and Three Thousand, Eight Hundred and Seventy Eight (103,878) fully vested Plan stock options (which consists of all of Optionee's vested stock Options as of the Effective Date) is hereby extended to December 31, 2007, irrespective of the date that Optionee's services to the Company terminate.

(b) The exercise extension provided for in Section (a) above is subject to the following conditions and restrictions:

(i) Immediately upon termination of Optionee's employment as provided for in the Employment Agreement between the Company and Optionee, Optionee shall execute and sign a full release of all claims against the Company in the form attached as Exhibit I, which is that Company's standard employment related release of claims. In the event Employee elects not to sign the release of claims immediately upon the termination of the Employment Agreement, Employee agrees that all then outstanding Employee Stock Options shall then immediately terminate.

(ii) No shares of common stock of the Company owned by Optionee may be sold by or on behalf of Optionee during the initial 90-day period from July 25, 2006 through October 23, 2006; (b) Optionee may sell up to 25,971 shares of common stock owned by her beginning October 24, 2006; (c) and Optionee may sell an additional 25,969 shares beginning on January 21, 2007 and each ninety days thereafter until July 20, 2007 when 100% of Optionee's shares of common stock (and/or options exercisable for common stock) in the Company shall be fully tradable. The trade restrictions listed above shall be eliminated once the per-share trading price of the Company's common stock on the Nasdaq exchange closes at or above $13 per share, or if the 30 day average daily stock volume reaches 50,000 shares.

(c) All stock options previously granted to Optionee that are not vested as of the Effective Date of this Agreement are hereby terminated as of the Effective Date.

(d) Except as specifically set forth herein, all other terms and conditions of the Plans and the Plan Agreements shall remain in full force and effect.

IN WITNESS WHEREOF, this Agreement has been executed and delivered by the parties on the Effective Date.

OPTIONEE:	COMPANY:
Elizabeth A. Scarbrough	Cytori Therapeutics, Inc.
/s/ Elizabeth A. Scarbrough	By: /s/ Mark E. Saad Name: Mark E. Saad Title: Chief Financial Officer

EXHIBIT 10.37

EMPLOYMENT AGREEMENT

THIS AGREEMENT is entered into as of July 25, 2006 (the "Effective Date"), by and between Cytori Therapeutics, Inc., a Delaware corporation located at 3020 Callan Road, San Diego, CA 92121 ("Company"), and Bruce A. Reuter, an individual ("Employee").

Whereas, the Company has eliminated the position of Senior Vice President, Business Development on July 25, 2006; and

Whereas, the Company and Employee wish to continue the Employment relationship in a new capacity through January 20, 2007;

Now therefore, in consideration of the mutual promises made by the parties to this Agreement, the parties agree as follows:

1. Duties and Compensation

(a) Employee is engaged by the Company as its Strategic Business Development Advisor with duties as directed by the CEO and otherwise customarily associated with that position.

(b) The Company shall pay to Employee in exchange for the services to be rendered hereunder a salary of Seventeen Thousand Five Hundred Dollars [$17,500.00] per month, payable twice a month on the fifteenth and last days of each month during which this Agreement is in force.

2. Guaranteed Duration

The term of this Agreement shall commence on July 25, 2006 and shall end on January 20, 2007 (the"Term") unless extended by mutual agreement. The employment relationship created by this Agreement is "at will" and may be terminated by either the Company or Employee at any time, with or without cause. Should the Company terminate Employee without cause prior to January 20, 2007, Employee shall receive, as severance, the balance of his monthly salary payments that would have otherwise been payable from such date of early termination through January 20, 2007, plus Four Thousand Three Hundred and Seventy Five Dollars [$4,375].

3. Other Compensation / Benefits

Employee understands and agrees that by his employment hereunder he shall not earn or accrue the right to any additional paid time off (or "PTO"), nor shall he be eligible from the Effective Date of this Agreement to the vesting of any stock options through the Company's incentive stock option programs during the term of this Agreement. Employee also understands and agrees that he is eligible to participate in the Company's flexible benefits plan for 2006/2007, but he agrees not to submit for reimbursement of amounts in excess of that which he has paid into the plan.

Employee understands and agrees that he shall be entitled to participate in all other standard benefits offered by the Company.

4. Agreement Relating to Confidential Information

Employee agrees that he shall continue to be covered by the Company's Employment, Confidentiality and Assignment Agreement which he executed on May 17, 2001.

5. Noninterference

While employed by the Company and for two (2) years immediately following the termination of employment, Employee agrees not to interfere with the business of the Company by soliciting, attempting to solicit, inducing, or otherwise causing any employee of the Company to terminate his or her employment in order to become an employee, consultant or independent contractor to or for any competitor of the Company.

Employee agrees that the duties under Sections 4 and 5 of this Agreement shall survive termination of employment with the Company.

6. Governing Law

This Agreement and the rights and obligations of the parties shall be governed and construed by the substantive laws of the State of California as applied to contracts that are executed and performed entirely in California. Exclusive jurisdiction and venue for any dispute arising out of or related to this Agreement shall lie with the federal and state courts located in and serving San Diego County, California.

7. Complete Agreement; Amendments

This Agreement, together with the Stock Option Extension Agreement and the Employment, Confidentiality and Assignment Agreement between Employee and the Company, are the entire agreement of the parties with respect to the subject matter hereof and thereof and may not be amended, supplemented, canceled or discharged except by written instrument executed by both parties hereto. If either party should waive any breach of any provision of this Agreement, he, she or it shall not thereby be deemed to have waived any preceding or succeeding breach of the same or any other provision of this Agreement.

IN WITNESS WHEREOF, the parties have executed this Agreement as of the Effective Date.

EMPLOYEE:	COMPANY:
Bruce A. Reuter	Cytori Therapeutics, Inc.
/s/ Bruce A. Reuter	By: /s/ Christopher J. Calhoun Name: Christopher J. Calhoun Title: Chief Executive Officer

EXHIBIT 10.38

EMPLOYMENT AGREEMENT

THIS AGREEMENT is entered into as of July 25, 2006 (the "Effective Date"), by and between Cytori Therapeutics, Inc., a Delaware corporation located at 3020 Callan Road, San Diego, CA 92121 ("Company"), and Elizabeth A. Scarbrough, an individual ("Employee").

Whereas, the Company has eliminated the position of Vice President, Marketing & Development on July 25, 2006; and

Whereas, the Company and Employee wish to continue the Employment relationship in a new capacity through February 7, 2007;

Now therefore, in consideration of the mutual promises made by the parties to this Agreement, the parties agree as follows:

1. Duties and Compensation

(a) Employee is engaged by the Company as its Strategic Marketing & Development Advisor with duties as directed by the CEO and/or the President and otherwise customarily associated with that position.

(b) The Company shall pay to Employee in exchange for the services to be rendered hereunder a salary of Fifteen Thousand Four Hundred and Seventeen Dollars [$15,417.00] per month, payable twice a month on the fifteenth and last days of each month during which this Agreement is in force.

(c) In exchange for Company agreeing to enter into this Agreement, Employee shall be required to sign a full release of claims with respect to her past employment with the Company. The release shall be in the form attached hereto as Exhibit A. Company shall have the option to suspend its performance under this Agreement and the Stock Option Extension Agreement until such time as Employee has executed the full release of claims and the seven day period for revocation of the release has elapsed. In the event the release is not signed by Employee within the 45 day period, or in the event Employee revokes the release prior to the expiration of the 7 day revocation period, the parties agree that this Agreement and the Stock Option Extension Agreement shall immediately terminate and Company shall have no obligations to Employee under this Agreement, and all outstanding Company stock options described in the Stock Option Extension Agreement shall immediately terminate in their entirety.

2. Guaranteed Duration

The term of this Agreement shall commence on July 25, 2006 and shall end on February 7, 2007 (the"Term") unless extended by mutual agreement. The employment relationship created by this Agreement is "at will" and may be terminated by either the Company or Employee at any time, with or without cause. Should the Company terminate Employee without cause prior to February 7, 2007, Employee shall receive, as severance, the balance of her monthly salary payments that would have otherwise been payable from such date of early termination through February 7, 2007.

3. Other Compensation / Benefits / Acknowledgements

Employee understands and agrees that by her employment hereunder that she shall not earn or accrue the right to any additional paid time off (or "PTO"), nor shall she be eligible from the Effective Date of this Agreement to the vesting of any stock options through the Company's incentive stock option programs during the term of this Agreement. Employee expressly acknowledges and agrees that this Agreement shall serve as full and final compensation for any and all PTO that she may have accrued prior to the Effective Date. Employee also understands and agrees that she is eligible to participate in the Company's flexible benefits plan for 2006/2007, but she agrees to not to submit for reimbursement of amounts in excess of that which she has paid into the plan.

Employee understands and agrees that she shall be entitled to participate in all other standard benefits offered by the Company through the term of this Agreement.

4. Agreement Relating to Confidential Information

Employee agrees that she shall continue to be covered by the Company's Employment, Confidentiality and Assignment Agreement which she executed on March 28, 2003.

5. Noninterference

While employed by the Company and for two (2) years immediately following the termination of employment, Employee agrees not to interfere with the business of the Company by soliciting, attempting to solicit, inducing, or otherwise causing any employee of the Company to terminate his or her employment in order to become an employee, consultant or independent contractor to or for any competitor of the Company.

Employee agrees that the duties under Sections 4 and 5 of this Agreement shall survive termination of employment with the Company.

6. Governing Law

This Agreement and the rights and obligations of the parties shall be governed and construed by the substantive laws of the State of California as applied to contracts that are executed and performed entirely in California. Exclusive jurisdiction and venue for any dispute arising out of or related to this Agreement shall lie with the federal and state courts located in and serving San Diego County, California.

7. Complete Agreement; Amendments

This Agreement, together with the Stock Option Extension Agreement and the Employment, Confidentiality and Assignment Agreement between Employee and the Company (including all exhibits and attachments thereto), are the entire agreement of the parties with respect to the subject matter hereof and thereof and may not be amended, supplemented, canceled or discharged except by written instrument executed by both parties hereto. If either party should waive any breach of any provision of this Agreement, he, she or it shall not thereby be deemed to have waived any preceding or succeeding breach of the same or any other provision of this Agreement.

IN WITNESS WHEREOF, the parties have executed this Agreement as of the Effective Date.

EMPLOYEE:

Elizabeth A. Scarbrough

/s/ Elizabeth A. Scarbrough

COMPANY:

Cytori Therapeutics, Inc.

By: Mark E. Saad
Name: Mark E. Saad
Title: Chief Financial Officer

AMENDED AND RESTATED
EXCLUSIVE LICENSE AGREEMENT

for

ADIPOSE-DERIVED STEM CELLS

This amended and restated exclusive license agreement ("Agreement") is made effective this 6th day of September, 2006 ("Effective Date"), between The Regents of the University of California, a California corporation, having its statewide administrative offices at 1111 Franklin Street, 12th Floor, Oakland, California 94607-5200 ("The Regents"), and Cytori Therapeutics, Inc., a Delaware corporation, having a principal place of business at 3020 Callan Road, San Diego, CA 92121 ("Licensee").

BACKGROUND IN CONNECTION WITH THE AMENDMENT AND RESTATEMENT

A. The Regents and StemSource, Inc. entered into that certain Exclusive License Agreement for Adipose-Derived Stem Cells (U.C. Agreement Control Number 2002-03-0194) effective October 16, 2001 (the "License Agreement"), as amended by the Amendment to Exclusive License Agreement between The Regents and StemSource, Inc. dated January 23, 2002, and by the Consent Of Substitution Of Party dated November 8, 2002 pursuant to which Cytori Therapeutics, Inc (formerly MacroPore Biosurgery, Inc.) was substituted in as the exclusive licensee to The Regents interest in certain Inventions (as described below), under terms and conditions set forth in the License Agreement.

B. The Regents and Licensee have recently reached a mutual understanding that the License Agreement drafted in 2001 no longer accurately reflected the business model of the Licensee, and that it contained certain restrictions and milestones that were not optimal for the commercialization of the Invention portfolio.

C. In light of these issues, the parties have agreed to amend and restate the License Agreement to maximize the commercial potential for the Inventions, the interests of the parties and the public good.

BACKGROUND OF THE INVENTIONS

A. Certain inventions, generally characterized as "Adipose-Derived Stem Cells and Lattices" ("Inventions"), were made in the course of research at the University of California, Los Angeles by Drs. Marc H. Hedrick, H. Peter Lorenz, Prosper Benhaim and Min Zhu ("Regents' Inventors") and as of the Effective Date named inventors at the University of Pittsburgh ("Pittsburgh") include Drs. Adam J. Katz, J. Ramón Llull and J. William Futrell ("Pittsburgh's Inventors") (collectively, the "Inventors"). The Inventions are disclosed in UC Case No. 2000-310 and are covered by Patent Rights as defined below.

B. Licensee acknowledges that The Regents and Pittsburgh have not entered into any agreement that sets out the rights of each in regards to patent prosecution matters, inventorship, or licensing of the Inventions.

C. Licensee acknowledges that Pittsburgh has filed and taken the lead in prosecuting PCT/US00/06232 (filed 03/10/2000 and designating the US) and The Regents has filed and taken the lead in prosecuting a Continuation-in-Part application (filed 09/10/2001). No decisions have been made by the parties concerning Patent Rights.

D. Licensee acknowledges that certain of the Inventions may be jointly owned by The Regents and Pittsburgh and that each party is licensing its interest in Patent Rights independently of the other.

E. Licensee acknowledges and agrees that the rights granted under this Agreement may be limited by Pittsburgh's joint ownership or sole ownership in certain claims under Patent Rights, and the licenses granted under this Agreement are granted solely under The Regents undivided interest in Patent Rights, whatever those rights might be.

F. Licensee wishes to obtain rights from The Regents for the exclusive commercial development, use and sale of products from The Regents' interest in the Inventions, and The Regents is willing to grant those rights so that the Inventions may be developed to their fullest and the benefits enjoyed by the general public.

G. Licensee is "a small business firm" as defined in 15 U.S.C. § 632.

H. Licensee and The Regents recognize and agree that (subject to Sections 2.2 and 2.3 below) royalties due under this Agreement on products and methods will be paid by Licensee on both pending patent applications and issued patents.

In view of the foregoing, the parties agree:

1. DEFINITIONS

"Affiliate" **means any corporation or other business entity: (i) in which Licensee owns or controls, directly or indirectly, at least fifty percent (50%) of the outstanding stock or other voting rights entitled to elect directors; or (ii) which owns, directly or indirectly, at least fifty percent (50%) of the outstanding stock or other voting rights entitled to elect directors of the Licensee; or (iii) which is under common ownership or control with Licensee to the extent of at least fifty percent (50%) of the outstanding stock or other voting rights entitled to elect directors. Notwithstanding the foregoing, in any country where the local law does not permit foreign equity participation of at least fifty percent (50%), then an "Affiliate" includes any company in which Licensee owns or controls, or is owned or controlled by, or is under common ownership or control with, directly or indirectly, the maximum percentage of outstanding stock or voting rights permitted by local law.**

"Licensed Method" **means any method that is covered by or claimed in Patent Rights, or the use of which would constitute, but for the license granted to Licensee under this Agreement, an infringement of any unexpired claim of a patent or pending claim of a patent application included in Patent Rights.**

"Licensed Product" **means any product that is covered by or claimed in Patent Rights; that is used in a manner requiring the performance of the Licensed Method; that is produced by the Licensed Method or that the manufacture, use or sale of which would be an infringement, but for the license granted to Licensee pursuant to this Agreement, of an unexpired claim of a patent or pending claim of a patent application included in Patent Rights. This definition of**

Licensed Product also includes a service either used by Licensee or an Affiliate or sublicensee or provided by Licensee an Affiliate or sublicensee to its customers when such service requires the use of Licensed Product or performance of Licensed Method.

"Research Product" **means a Licensed Product that is not a Clinical Product and is sold for research purposes or drug discovery purposes, i.e. an assay for identifying or validating human therapeutic drugs.**

"Clinical Product" **means a Licensed Product which, were it sold in the United States, would require regulatory approval from the United States Food and Drug Administration.**

"Product" **means Research Product and Clinical Product.**

1.7 **"Field"** means any and all products and/or services for the research, diagnosis, and/or therapy of disease and/or dissorders in humans and for cosmetic applications in humans.

1.8 **"Net Sales"** means the total of the gross invoice prices from the Final Sale of Product, or Licensed Method performed by Licensee or an Affiliate, less the sum of the following actual and customary deductions where applicable: cash, trade or quantity discounts; sales, use, tariff, import/export duties or other excise taxes imposed on particular sales (excepting value added taxes or income taxes); transportation charges, including insurance; and allowances or credits to customers because of rejections or returns. Final Sale means the last sale within the control of Licensee or an Affiliate to an independent third party (including without limitation to distributors and agents). If the Licensee or an Affiliate sells Licensed Products to a sublicense, an Affiliate or the Licensee for the recipient's end use (and not for resale, clinical studies, clinical trials, or other research to promote commercialization), then such sales will be considered a Final sale at the price normally charged to independent, unaffiliated third parties at the time of such end use sale or, if there is no such price, at the fair market value thereof at the time of such end use sale. Any sale of a Product by Licensee or an Affiliate to an Affiliate, the Licensee, or a sublicensee will not be considered a Final Sale where such sale is not for end use by Licensee, an Affiliate or a sublicensee. If Licensee or an Affiliate sells at a single price or rate a packaged combination of products (or "Kit"), not all of which if sold individually would be Licensed Products, then "Net Sales" with respect to such sales of such Kit or packaged products shall equal the number of units of Licensed Products sold as part of such Kit (less rejections, defects and returns) multiplied by either (i) the respective average net selling price during such period of the same type of Licensed Product sold individually, or (ii) the average net selling price during such period for a comparable product (if the same type of Product is not sold individually), in either case excluding sales, use or excise tax, freight, duty or insurance included therein. ***.

Additionally, for the avoidance of doubt, if such product is an indivisible component of a larger product, composition of matter or combination product (the components of which cannot be sold separately), then such composition of matter or combination product is deemed in its entirety to be a Licensed Product for purposes of this definition.

1.9 "Patent Rights" **means The Regents' undivided interest in the following United States patents and patent applications, corresponding foreign patents and patent applications, and any reissues, extensions, substitutions, continuations, divisions, and continuation-in-part applications but excluding continuation-in-part applications (to the extent that claims are not supported in the parent);**

1.9.1 United States Patent Application No. 60/123,711 entitled "Isolation of Stromal Cells from Adipose Tissue," filed March 10, 1999, by Dr. Marc Hedrick et al (UC Case 2000-310-1) - inactive;

1.9.2. United States Patent Application No. 60,162,462 entitled "Isolation of Mesenchymal Stem Cells from Adipose Tissue," filed October 29, 1999, by Dr. Marc Hedrick et al. (UC Case No. 2000-301-2) - converted;

1.9.3 United States Patent Application No. 09/947,985 entitled "Adipose-Derived Stem Cells and Lattices," filed Sept. 6, 2001, by Adam Katz et al (UC Case No. 2000-310-3), abandoned;

1.9.4 United States Patent Serial No. 6,777,231 entitled "Adipose-Derived Stem Cells and Lattices," issued August 17, 2004 by Dr. Marc Hedrick et al (UC Case 2000-310-4).;

1.9.5 United States Patent Application No. 09/952,522 entitled "Adipose-Derived Stem Cells and Lattices," filed September 10, 2001, by Dr. Marc Hedrick et al.; (UC Case No. 2000-310-5) now abandoned;

1.9.6 United States Patent Application No.10/651,564 entitled 'Adipose-Derived Stem Cells and Lattices," filed August 29, 2003, by Dr. Adam J. Katz et al.; (UC Case No. 2000-310-6);

1.9.7 United States Patent Application No. 10/740,315 entitled "Adipose-Derived Stem Cells and Lattices," filed December 17, 2003, by Dr. Dr. Marc Hedrick et al.; (UC Case No. 2000-310-7);

1.9.8 United States Patent Application No. 10/797,371 entitled "Adipose-Derived Stem Cells and Lattices," filed March 9, 2004, by Dr. Adam Katz et al.; (UC Case No. 2000-310-8);

1.9.9 United States Patent Application No. 10/845,315 entitled "Adipose-Derived Stem Cells and Lattices," filed May 12, 2004, by Dr. Adam Katz et al.; (UC Case No. 2000-310-9);

1.9.10 United States Patent Application No. 11/211,114 entitled "Adipose-Derived Stem Cells and Lattices," filed August 24, 2005, by Dr. Marc Hedrick et al.; (UC Case No. 2000-310-A).

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***Material has been omitted pursuant to a request for confidential treatment filed separately with the Securities and Exchange Commission.

2. LIFE OF PATENT EXCLUSIVE GRANT

2.1 Subject to the limitations set forth in this Agreement, The Regents grants to Licensee a world-wide license under The Regents' undivided interest in Patent Rights to make, have made, use, sell, offer to sell and import Product and to practice Licensed Method in the Field to the extent permitted by law.

2.2 The Regents acknowledge Licensee is currently commercializing an automated device called “Celution”, which when operated in conjunction with various disposable component parts is capable of producing a heterogeneous isolate of the material naturally occurring in adipose tissue including unmodified amounts of stem cells and other regenerative cells (hereafter “PLA”), intended for human therapeutic, diagnostic, cosmetic and other uses;

2.3 Licensee and the Regents acknowledge and agree that (except as provided below in this Paragraph 2.3) Licensee’s Celution device and PLA shall be deemed not to be included in or covered by the Patent Rights for purposes of this License, and that such exclusion shall not constitute an admission by The Regents that the Celution device or the PLA are not encompassed, either in whole or in part, within the Regents Patent Rights. Nor shall the Regents be barred from later requiring that the Celution device and PLA be governed by the terms of this Agreement in the event (and to the extent) of any subsequent issuance of claims under prosecution in the Patent Rights that would cause either Licensees Celution device or PLA to fall within the category of “Licensed Products” or “Licensed Methods”. In no event shall any subsequent royalty associated with Licensees Celution device or the PLA exceed ***.

2.4 Licensee acknowledges that Pittsburgh has the right to grant licenses to its undivided interest in Patent Rights.

***2.5 Except as otherwise provided in this Agreement, the license granted in Paragraph* 2.1 is exclusive for the life of the Agreement.**

2.6 The Regents reserves the right to practice, and for other educational and non-profit institutions to practice, the Inventions and associated technology for educational and research purposes, including publication and other communication of research results.

3. SUBLICENSES

3.1 The Regents also grants to Licensee the right to issue sublicenses to third parties to make, have made, use, sell, and offer to sell and import Products and to practice Licensed Method, as long as Licensee has current exclusive rights thereto under this Agreement, except that the sublicensee may not be granted the right to further sublicense the technology without the prior approval by The Regents, which approval shall be granted only upon Licensees provision of substantial assurances that the Regents interests in the technology will at all times be maintained. To the extent applicable, sublicenses must include all of the rights of and obligations due to The Regents contained in this Agreement. The Licensee will not issue additional paid-up sublicenses without prior written approval of The Regents. For the avoidance of doubt, Licensee’s Affiliates are not licensed under this Agreement, except by a written sublicense agreement under this Article 3. And furthermore, The Regents hereby acknowledges and approves the sublicense issued by Licensee to Olympus-Cytori, Inc, entitled License/Commercial Agreement dated November 4, 2005, and acknowledges additionally that such sublicense is fully paid-up with respect to the Regents for the life thereof.

3.2 The Licensee will pay to The Regents *** under each sublicense agreement issued for the purpose of development or commercialization of Products (the “Purpose”) after the Effective Date (“Sublicensing Revenue”). Sublicensing Revenue will be the sole form of compensation payable to the Regents by Licensee with respect to any and all sublicenses granted hereunder. Sublicensing Revenue will not include the following: *** **The operations of all sublicensees will be deemed to be the operations of the Licensee, for which the Licensee will be responsible. The Licensee will notify The Regents of each sublicense granted hereunder and provide The Regents with a complete copy**

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***Material has been omitted pursuant to a request for confidential treatment filed separately with the Securities and Exchange Commission.

of each sublicense within thirty (30) days of issuance of the sublicense. The Licensee will pay to The Regents all Sublicensing Revenue due in accordance with Article 4 (Sublicenses) below on or before the due date of the royalty report applicable to the quarter in which the Sublicensing Revenue is due to The Regents, in accordance with Section 4.1. The Licensee will require the sublicensees to provide it with Progress Reports and royalty reports in accordance with the provisions herein, and the Licensee will collect and deliver to The Regents all such reports due from the sublicensees. For avoidance of doubt, *.***

3.3 In the event that The Regents rights to United States Patent Serial No. 6,777,231 are finally determined not to be solely owned and assigned to The Regents in connection with the pending Complaint for Correction of Inventorship by the University of Pittsburgh vs. Hedrick et al. (U.S. Disc. Ct., C.D. Cal, Case No. CV 04-9014 CBM (AJWX)) (the “Complaint”), or ***.

3.4 Upon termination of this Agreement for any reason, The Regents, will enter into written agreements with all sublicensees then in compliance with their obligations under this Agreement and who are willing to enter into direct agreements with The Regents on terms no less favorable to such sublicensees than set forth in their respective sublicense agreements. In no case, however, will The Regents be bound by duties and obligations contained in any sublicense that extend beyond the duties and obligations of The Regents set forth in this Agreement.

4. PAYMENT TERMS

4.1 Paragraphs 1.9, 1.2 and 1.3 define Patent Rights, Licensed Method, and Licensed Product so that royalties are payable on products and methods covered by both pending patent applications and issued patents (subject to Paragraphs 2.1 and 2.3). Royalties will accrue in each country for the duration of Patent Rights in that country and are payable to The Regents thirty (30) days after the Product is invoiced or if not invoiced, when delivered to a third party. Sublicensing Revenue will accrue in each country for the duration of Patent Rights in that country and are payable to The Regents thirty (30) days after payment is due to the Licensee under the sublicense agreement.

4.2 Licensee will pay to The Regents earned royalties and Sublicensing Revenue quarterly on or before February 28, May 31, August 31 and November 30 of each calendar year. Each payment will be for earned royalties and Sublicensing Revenue accrued within Licensee's most recently completed calendar quarter.

4.3 All monies due The Regents are payable in U.S. dollars. Licensee is responsible for all bank transfer charges. When Product is sold for monies other than U.S. dollars, Licensee will first determine the earned royalty in the currency of the country in which Product was sold and then convert the amount into equivalent U.S. funds, using the exchange rate quoted in The Wall Street Journal on the last business day of the reporting period.

4.4 Sublicensing Revenue and royalties earned on sales occurring in any country outside the U.S. may not be reduced by any taxes, fees or other charges imposed by the government of such country on the payment of royalty income. Notwithstanding the foregoing, all payments made by Licensee in fulfillment of The Regents' tax liability in any particular country will be credited against earned royalties or fees due The Regents for that country.

4.5 If at any time legal restrictions prevent the prompt remittance of royalties by Licensee from any country where a Product is sold or Sublicensing Revenue accrued, then Licensee will deposit the amount owed to The Regents into an interest bearing account and will pay The Regents directly from this account or from its U.S. source of funds within a year of the due date.

4.6 If any patent or patent claim within Patent Rights is abandoned or held invalid in a final decision by a court of competent jurisdiction and last resort and from which no appeal has or can be taken, then all obligation to pay royalties or Sublicensing Revenue based on that patent or claim or any claim patentably indistinct there from will cease as of the date of final decision. Licensee will not, however, be relieved from paying any royalties that accrued before the final decision or that are based on another patent or claim not involved in the final decision or that are based on The Regents' property rights.

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***Material has been omitted pursuant to a request for confidential treatment filed separately with the Securities and Exchange Commission.

4.7 In the event payments, rebillings or fees are not received by The Regents when due, Licensee will pay to The Regents interest charges at a rate of ten percent (10%) per annum. Interest is calculated from the date payment was due until actually received by The Regents.

5. LICENSE AMENDMENT CONSIDERATION

5.1 As consideration for this amendment and restating of the Agreement, the Licensee will issue to The Regents one hundred thousand (100,000) shares of common stock ("the Stock") of Cytori Therapeutics, Inc, within seven (7) days of the Effective Date of this Agreement or of the date Licensee receives notice from The Regents that The Regents' Office of the President has approved acceptance of Stock, whichever is later. Licensee will use reasonable efforts to, within sixty (60) business days after such issuance, prepare and file with the US Securities and Exchange Commission (the "Commission") a Registration Statement covering the resale of the Shares for an offering to be made on a continuous basis pursuant to Rule 415. The Registration Statement will be on Form S-3 (except if Licensee is not then eligible to register for resale the Shares on Form S-3, in which case such registration will be on another appropriate form in accordance with the US Securities Act and the rules promulgated there under). Licensee will use its reasonable efforts to cause the Registration Statement to be declared effective under the US Securities Act within ninety (90) business days after such filing. Licensee will keep such Registration Statement continuously effective under the Securities Act for a period of two (2) years (the "Effectiveness Period"). The Regents represents that they would acquire the Shares for their own account for investment, and not with a view to any distribution, which would violate any applicable securities laws. The Regents acknowledges that they have not received and are not relying upon any advice, representations or assurances made by or on behalf of the Licensee or any Licensee affiliate or any employee of or counsel to Licensee regarding the Shares. The Regents may transfer, or direct Licensee to transfer, to Regents' Inventors an inventor share portion of the Stock under Regent's Patent Policy.

6. LICENSE MAINTENANCE FEE AND MILESTONE PAYMENTS

6.1 Licensee will also pay to The Regents a royalty in the form of a license maintenance fee as follows:

6.1.1 Fifty Thousand Dollars ($50,000) on or before June 30, 2008;

6.1.2 Fifty Thousand Dollars ($50,000), on or before June 30, 2009;

6.1.3 Seventy-Five Thousand Dollars ($75,000) on or before June 30, 2010;

6.1.4 One Hundred Thousand Dollars ($100,000) on or before June 30, 2011;

6.1.5 One Hundred Thousand Dollars ($100,000) on or before June 30, 2012; and,

6.1.6 One Hundred Thousand Dollars ($100,000) on or before June 30, 2013.

6.2 The license maintenance fee is not due on any anniversary of the Effective Date if Licenseeis commercially selling Product on that date and paying an earned royalty to The Regents on the sales of that Licensed Product. License maintenance fees are non-refundable and not an advance against earned royalties.

7. EARNED ROYALTIES AND MINIMUM ANNUAL ROYALTIES

*7.1 Licensee will also pay to The Regents an earned royalty of *** based on the Net Sales of Product sold by the Licensee.*

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***Material has been omitted pursuant to a request for confidential treatment filed separately with the Securities and Exchange Commission.

*7.2 In the event that it becomes necessary for Licensee to license patent rights owned by third parties to make, have made, use or sell Clinical Product, then the Licensee will have the right to obtain the patent rights from such third party ***.*

7.3 Licensee will pay to The Regents a minimum annual royalty for the life of Regents' Patent Rights beginning in the year of the first commercial sale of Product or Licensed Method but no later than *. Minimum annual royalties will be as follows:**

7.3.1. *;**

7.3.2 *;**

7.3.3 *.**

7.4 The minimum annual royalty will be paid semi-annually to The Regents on February 28 and July 31 of each year and will be credited against the earned royalty due for the calendar year in which the minimum payment was made.

8. DUE DILIGENCE

8.1 Licensee, upon execution of this Agreement, will diligently proceed with the development, manufacture and sale of Product and will earnestly and diligently endeavor to market the same within a reasonable time after execution of this Agreement and in quantities sufficient to meet market demands.

8.2 Licensee will endeavor to obtain all necessary governmental approvals for the manufacture, use and sale of Licensed Product.

8.3 Licensee, or its sublicense(s), will develop and commercialize a Research Product and will develop and commercialize a Clinical Product in the diagnostic field and/or in the therapeutic or cosmetic field as follows:

8.3.1 *; and will fill the market demand for such Research Product following commencement of marketing at any time during the exclusive period of this Agreement;**

8.3.2 Licensee will complete the following for a Clinical Product in the diagnostic field (i.e. a Clinical Product intended to diagnosis, prognosis or monitoring of disease in humans):

(i) ***, and market such Clinical Product in the United States within six (6) months of receiving marketing approval;

(ii) Fill the market demand for such Clinical Product following commencement of marketing at any time during the exclusive period of this Agreement; and/or**,**

8.3.3 Licensee will complete the following for a Clinical Product in the therapeutic field (i.e. intended to treat or ameliorate disease in humans or intended for cosmetic applications);

(i) *;**

(ii) ***; and

(iii) ***;

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***Material has been omitted pursuant to a request for confidential treatment filed separately with the Securities and Exchange Commission.

(iv) ***;

(v) ***;

(vi) ***; and

(vii) Fill the market demand for such Clinical Products following commencement of marketing at any time during the exclusive period of this Agreement.

Licensee's completion of Paragraph 8.3.2 or 8.3.3 above will be considered fulfillment of Licensee's obligation to develop a Clinical Product hereunder.

8.4 If Licensee (or a sublicense) is unable to perform any of the above diligence provisions, then The Regents may terminate this Agreement and its licenses or reduce the licenses hereunder to non-exclusive licenses. Notwithstanding the foregoing, if the Licensee is in compliance with diligence provisions for the Research Product and fails to meet a diligence provision for the Clinical Product, or vice-versa, under Paragraph 8.3 above, then The Regents' may terminate or reduce the exclusivity for the Product for which the diligence provision is unmet but not for the Product for which diligence is met. Moreover, if the Licensee can demonstrate to The Regents' reasonable satisfaction that a milestone at issue for Clinical Product has been determined to be impracticable for commercialization, then The Licensee and The Regents will negotiate revised due diligence for Clinical Products. If the Licensee fails to meet a diligence provision for Clinical Product and cannot demonstrate that the milestone at issue for has been determined impractical for commercialization, then the Regents has the right to terminate the licenses granted hereunder or reduce such licenses for Clinical Products to non-exclusive licenses. The right, if exercised by The Regents, supersedes the rights granted for such Products in Article 2 (Life of Patent Exclusive Grant).

8.5 Licensee will endeavor to develop Products through research performed at the University of California, Los Angeles in the amount of fifty thousand dollars ($50,000) in research funding by Licensee per year for six (6) years, beginning in the year 2007. Both parties will endeavor to combine the research funding provided by Licensee with UC Discovery grants and/or the BioStar research programs (or any similar research fund matching programs then in effect), and Licensee will have sole discretion with respect to the development and design of such research. In accordance with the disclosure and licensing terms of the research agreement(s) executed by The Regents and the License, The Regents will disclose, and offer to license The Regents' interest in patent rights claiming, inventions made and reduced to practice under such research agreements. Licensee will be released from the requirement to provide research funding in the event that this Agreement is terminated for any reason.

8.6 **The due diligence provisions of this Article 8 (Earned Royalties and Minimum Annual Royalties) shall not apply to, or effect Licensee's rights to Celution Product and/or PLA., if any such rights are later deemed to be covered by this License pursuant to Paragraph 2.3.**

9. PROGRESS AND ROYALTY REPORTS

9.1 During the life of this Agreement Licensee will submit to The Regents a written progress report covering Licensee's (and any Affiliate's or sublicensee's) activities related to the development and testing of all Products and the obtaining of the governmental approvals necessary for marketing. Progress reports are due

on August 15 and on February 15 of each year and will cover the Licensee's activities for the preceding January 1 through June 30 and July 1 through December 31, respectively. Progress reports are required for each Product until the first commercial sale of that Product occurs in the U.S. and will be again required if commercial sales of such Product are suspended or discontinued.

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***Material has been omitted pursuant to a request for confidential treatment filed separately with the Securities and Exchange Commission.

9.2 Progress reports submitted under Paragraph 9.1 will include, but are not limited to, the following topics:

9.2.1 Summary of work completed;

9.2.2 Key scientific discoveries;

9.2.3 Summary of work in progress;

9.2.4 Current schedule of anticipated events or milestones;

9.2.5 Market plans for introduction of Licensed Product; and

9.2.6 A summary of resources (dollar value) spent in the reporting period.

9.3 Licensee has a continuing responsibility to keep The Regents informed of the large and small business entity status as defined by the U.S. Patent and Trademark Office of itself and its sublicensees and Affiliates.

9.4 Licensee will report to The Regents in its immediately subsequent progress and royalty report the date of first commercial sale of a Product in each country.

9.5 After the first commercial sale of a Product anywhere in the world, Licensee will make quarterly royalty reports to The Regents on or before each February 28 (for the quarter ending December 31), May 31 (for the quarter ending March 31), August 31 (for the quarter ending June 30) and November 30 (for the quarter ending September 30) of each year. Each royalty report will cover Licensee's most recently completed calendar quarter and will show:

9.5.1 The gross sales and Net Sales of Product sold during the most recently completed calendar quarter;

9.5.2 The number of Product and sold;

9.5.3 The royalties, in U.S. dollars, payable with respect to sales of Product;

9.5.4 The method used to calculate the royalty;

9.5.5 The exchange rates used;

9.5.6 Sublicensing Revenue accrued during the previous quarter;

9.5.7If no sales of Product are made during any reporting period, then the Licensee will so state in the subsequent royalty report.

10. BOOKS AND RECORDS

10.1 Licensee will keep accurate books and records showing all Product, developed, **manufactured, used and/or sold under the terms of this Agreement, as well as all Sublicensing Revenue owed to The Regents under the terms of this Agreement. Books and records must be preserved for at least five (5) years from the date of the royalty payment to which they pertain.**

10.2 Books and records must be open to inspection by representatives or agents of The Regents at reasonable times. The Regents will bear the fees and expenses of examination but if an error in royalties of more than five percent (5%) of the total royalties or Sublicensing Revenue due for any year is discovered in any examination, then Licensee will bear the fees and expenses of that examination.

11. LIFE OF THE AGREEMENT

11.1 Unless otherwise terminated by operation of law, Paragraph 11.2, or by acts of the parties in accordance with the terms of this Agreement, this Agreement will remain in effect from the Effective Date until the expiration or abandonment of the last of the Patent Rights licensed hereunder.

11.2 This Agreement will become immediately terminable by either party upon the insolvency of the Licensee.

11.3 Any termination or expiration of this Agreement will not affect the rights and obligations set forth in the following Articles:

Article 1	Definitions
Article 5	Payment Terms
Article 10	Books and Records
Article 14	Disposition of Product on Hand upon Termination
Article 15	Use of Names
Article 16	Limitation of Liability
Paragraphs 17.5 and 17.6	Patent Prosecution and Maintenance
Article 20	Indemnification
Article 21	Notices
Article 25	Governing Laws; Venue; Attorneys' Fees
Article 29	Secrecy

11.4 The termination or expiration of this Agreement will not relieve the Licensee of its obligation to pay any fees, royalties, reimbursements for Patent Prosecution Costs, or other payments owed to the Regents at the time of such termination or expiration and will not impair any accrued right of The Regents, including the right to receive earned royalties and other consideration in accordance with Articles 3, 4, 8, and 15.

12. TERMINATION BY THE REGENTS

12.1 Subject to Paragraph 8.4, if Licensee fails to perform or violates any term of this Agreement, then The Regents may give written notice of default ("Notice of Default") to Licensee. If a Notice of Default is issued for non-payment of a fee or patent prosecution cost reimbursement owed hereunder, the Licensee must cure the default within sixty (60) days of the effective date of Notice of Default. If a Notice of Default is issued for something other than a payment of monies owed hereunder then the Licensee must cure the default within ninety (90) days of effective date of Notice of Default. If the Licensee fails to cure the material default within the time required above, The Regents may terminate this Agreement and its licenses by a second written notice ("Notice of Termination"). If a Notice of Termination is sent to Licensee, then this Agreement will automatically terminate on the effective date of that notice. Such termination will not relieve Licensee of its obligation to pay any fees owing at the time of termination and will not impair any accrued right of The Regents. These notices are subject to Article 21 (Notices). These notices will be subject to Article 21 (Notices).

13. TERMINATION BY LICENSEE

13.1 Licensee has the right at any time to terminate this Agreement in whole or as to any portion of Patent Rights by giving notice in writing to The Regents. Such notice of termination will be subject to Article 20 (Notices) and termination of this Agreement will be effective sixty (60) days from the effective date of such notice.

13.2 Any termination under the above Paragraph 13.1 does not relieve Licensee of any obligation or liability accrued under this Agreement prior to termination or rescind any payment made to The Regents or anything done by Licensee prior to the time termination becomes effective. Termination does not affect in any manner any rights of The Regents arising under this Agreement prior to termination.

14. DISPOSITION OF PRODUCT ON HAND UPON TERMINATION

14.1 Upon termination of this Agreement, Licensee is entitled to dispose of all previously made or partially made Product, but no more, within a period of one hundred and twenty (120) days provided that the sale of Product is subject to the terms of this Agreement, including, but not limited to, the rendering of reports and payment of royalties required under this Agreement.

15. USE OF NAMES AND TRADEMARKS

15.1 Nothing contained in this Agreement confers any right to use in advertising, publicity or other promotional activities any name, trade name, trademark or other designation of either party hereto (including contraction, abbreviation or simulation of any of the foregoing). Unless required by law, the use by Licensee of the name "The Regents of the University of California" or the name of any campus of the University of California is prohibited.

15.2 The Regents is free to release to the inventors and senior administrators employed by The Regents the terms and conditions of this Agreement. If such release is made, then The Regents will give notice of the confidential nature and will request that the recipient does not disclose such terms and conditions to others. If a third party inquires whether a license to Patent Rights is available, then The Regents may disclose the existence of this Agreement and the extent of the grant in Article 2 (Life of Patent Exclusive Grant) to such third party, but will not disclose the name of Licensee or any other terms or conditions of this Agreement, except where The Regents is required to release information under either the California Public Records Act, a governmental audit requirement or other applicable law.

16. LIMITED WARRANTY

16.1 The Regents warrants to Licensee that it has the lawful right to grant this license.

16.2 This license and the associated Inventions are provided WITHOUT WARRANTY OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR ANY OTHER WARRANTY, EXPRESS OR IMPLIED. THE REGENTS MAKES NO REPRESENTATION OR WARRANTY THAT PRODUCT OR LICENSED METHOD WILL NOT INFRINGE ANY PATENT OR OTHER PROPRIETARY RIGHT.

16.3 IN NO EVENT MAY THE REGENTS BE LIABLE FOR ANY INCIDENTAL, SPECIAL OR CONSEQUENTIAL DAMAGES RESULTING FROM EXERCISE OF THIS LICENSE OR THE USE OF THE INVENTIONS OR PRODUCT.

16.4 This Agreement does not:

16.4.1 Express or imply a warranty or representation as to the validity or scope of any of Patent Rights;

16.4.2 Express or imply a warranty or representation that anything made, used, sold, offered for sale or imported or otherwise disposed of under any license granted in this Agreement is or will be free from infringement of patents of third parties;

16.4.3 Obligate The Regents to bring or prosecute actions or suits against third parties for patent infringement except as provided in Article 19 (Patent Infringement);

16.4.4 Confer by implication, estoppel or otherwise any license or rights under any patents of The Regents other than Patent Rights as defined in this Agreement, regardless of whether those patents are dominant or subordinate to Patent Rights; or,

16.4.5 Obligate The Regents to furnish any know-how not provided in Patent Rights.

17. PATENT PROSECUTION AND MAINTENANCE

17.1 In regard to PCT/US00/06232, filed by Pittsburgh, The Regents does not control patent prosecution and there is no agreement in place between The Regents and Pittsburgh regarding patent prosecution matters. This Agreement may need to be amended to take into account the provisions of any agreement reached between Pittsburgh and The Regents in regard to patent prosecution matters and the payment of patent costs by The Regents.

17.2 In regard to Patent Rights filed by and assigned solely to The Regents, as long as Licensee has paid patent costs as provided for in this Article 17 (Patent Prosecution and Maintenance), The Regents will diligently endeavor to prosecute and maintain the U.S. and foreign patents using counsel of its choice. The Regents will provide Licensee with copies of all relevant documentation so that Licensee may be informed of the continuing prosecution. Licensee agrees to keep this documentation confidential. The Regents' counsel will take instructions only from The Regents, but The Regents will consider input from the Licensee in its choice of patent counsel and, if the Licensee so requests, The Regents will suggest three patent attorneys from which the Licensee may choose one to prosecute and maintain Patent Rights, provided The Regents concur that a change of prosecution counsel is warranted.

17.3 The Regents will use reasonable effort to amend any patent application to include claims reasonably requested by Licensee to protect the products contemplated to be sold under this Agreement.

17.4 Licensee may request that The Regents obtain patent protection on the Inventions in foreign countries if available and if it so desires. Licensee will notify The Regents of its decision to obtain or maintain foreign patents not less than sixty (60) days prior to the deadline for any payment, filing or action to be taken in connection therewith. This notice concerning foreign filing must be in writing, must identify the countries desired and must reaffirm Licensee's obligation to underwrite the costs thereof. The absence of such a notice from Licensee to The Regents will be considered an election not to obtain or maintain foreign rights.

17.5 Licensee will bear The Regents' costs of preparing, filing, prosecuting and maintaining all U.S. and foreign patent applications contemplated by this Agreement. Costs billed by The Regents' counsel will be rebilled to Licensee and are due within thirty (30) days of rebilling by The Regents. These costs include patent prosecution costs for the Inventions incurred by The Regents prior to the execution of this Agreement and any patent prosecution costs that may be incurred for patentability opinions, re-examination, re-issue, interferences, oppositions and inventorship determinations, as well as the existing Complaint for Correction of Inventorship by the University of Pittsburgh vs. Hedrick et al. (U.S. Disc. Ct., C.D. Cal, Case No. CV 04-9014 CBM (AJWX) and any other filings in this case, including counterclaims and appeals**. Prior prosecution costs will be due upon execution of this Agreement and billing by The Regents.**

17.6 Licensee's obligation to underwrite and to pay patent prosecution costs will continue for so long as this Agreement remains in effect, but Licensee may terminate its obligations with respect to any given patent application or patent upon three (3) months' written notice to The Regents. The Regents will use its best efforts to curtail patent costs when a notice of termination is received from Licensee. The Regents may prosecute and maintain such application(s) or patent(s) at its sole discretion and expense, but Licensee will have no further right or licenses hereunder. Non-payment of patent costs may be deemed by The Regents as an election by Licensee not to maintain application(s) or patent(s).

17.7 The Regents may file, prosecute or maintain patent applications at its own expense in any country in which Licensee has not elected to file, prosecute or maintain patent applications in accordance with this Article 17 (Patent Prosecution and Maintenance) and those applications and resultant patents will not be subject to this Agreement.

17.8 Licensee will apply for an extension of the term of any patent included within Patent Rights under the Drug Price Competition and Patent Term Restoration Act of 1984 and/or European, Japanese and other foreign counterparts of this Law. Licensee will prepare all documents and The Regents agrees to execute the documents and to take additional action as Licensee reasonably requests in connection therewith.

17.9 If either party (in the case of The Regents: the Licensing Officer responsible for administration of this Agreement) receives notice pertaining to infringement or potential infringement of any issued patent included within Patent Rights under the Drug Price Competition and Patent Term Restoration Act of 1984 and/or foreign counterparts of this Law, then that party will notify the other party within ten (10) days after receipt of notice of infringement.

18. PATENT MARKING

18.1 Licensee will mark all Products made, used or sold under the terms of this Agreement, or their containers, in accordance with the applicable patent marking laws.

19. PATENT INFRINGEMENT

19.1 If Licensee learns of the substantial infringement of any patent licensed under this Agreement, then Licensee will call The Regents' attention thereto in writing and provide The Regents with reasonable evidence of infringement. Neither party will notify a third party of the infringement of any of Patent Rights without first obtaining consent of the other party, which consent will not be unreasonably denied. Both parties will use their best efforts in cooperation with each other to terminate infringement without litigation.

19.2 Licensee may request that The Regents take legal action against the infringement of Patent Rights. Such request must be in writing and must include reasonable evidence of infringement and damages to Licensee. If the infringing activity has not abated within ninety (90) days following the effective date of request, then The Regents has the right to:

19.2.1 Commence suit on its own account; or,

19.2.2 Refuse to participate in the suit, and,

The Regents will give notice of its election in writing to Licensee by the end of the one-hundredth (100th) day after receiving notice of written request from Licensee. Licensee may thereafter bring suit for patent infringement, at its own expense, if and only if The Regents elects not to commence suit and if the infringement occurred during the period and in a jurisdiction where Licensee had exclusive rights under this Agreement. If, however, Licensee elects to bring suit in accordance with this Paragraph 19.2, then The Regents may thereafter join that suit at its own expense. Licensee agrees not to bring suit for patent infringement without following the procedures of this Paragraph 19.2, and both parties agree to be bound by an order of a court for patent infringement, patent infringement issues and patent infringement defenses raised through the pendency of such a suit under this Paragraph 19.2.

19.3 Legal action, as is decided on, will be at the expense of the party bringing suit and all damages recovered thereby will belong to the party bringing suit, but legal action brought jointly by The Regents and Licensee and fully participated in by both will be at the joint expense of the parties and all recoveries will be shared jointly by them in proportion to the share of expense paid by each party.

19.4 Each party will cooperate with the other in litigation proceedings instituted hereunder but at the expense of the party bringing suit. Litigation will be controlled by the party bringing the suit, except that The Regents may be represented by counsel of its choice in any suit brought by Licensee.

20. INDEMNIFICATION

20.1 Licensee will indemnify, hold harmless and defend The Regents, its officers, employees and agents, the sponsors of the research that led to the Inventions and the inventors of the patents and patent applications in Patent Rights and their employers against any and all claims, suits, losses, liabilities, damages, costs, fees and expenses resulting from or arising out of exercise of this license or any sublicense. This indemnification includes, but is not limited to, any product liability.

20.2 Licensee, at its sole cost and expense, will insure its activities in connection with the work under this Agreement and obtain, keep in force and maintain insurance.

20.3 Licensee will maintain the following or an equivalent program of self-insurance while Products are not being tested or used in-vivo in humans:

Comprehensive or commercial form general liability insurance (contractual liability included) with limits as follows:

- Each Occurrence $ 2,000,000 ($7MI **Umbrella policy**)
- Products/Completed Operations Aggregate $5,000,000
- Personal and Advertising Injury $1,000,000 ($7MI **Umbrella policy**)
- General Aggregate (commercial form only) $2,000,000 ($7MI **Umbrella policy**)

The Licensee increasing the required insurance levels as follows, prior to using or testing Products in-vivo in humans:

- Each Occurrence $5,000,000
- Products/Completed Operations Aggregate $10,000,000
- Personal and Advertising Injury $5,000,000
- General Aggregate (commercial form only) $10,000,000

The coverage and limits referred to in this Paragraph 20.3 do not in any way limit the liability of Licensee. Licensee will furnish The Regents with certificates of insurance showing compliance with all requirements. Certificates must:

- Provide for thirty (30) days' advance written notice to The Regents of any modification.
- Indicate that The Regents has been endorsed as an additional Insured under the coverage referred to under the above.
- Include a provision that the coverage will be primary and will not participate with nor will be excess over any valid and collectable insurance or program of self-insurance carried or maintained by The Regents.

20.4 The Regents will notify Licensee in writing of any claim or suit brought against The Regents in respect of which The Regents intends to invoke the provisions of this Article 20 (Indemnification). Licensee will keep The Regents informed on a current basis of its defense of any claims under this Article 20 (Indemnification).

21. NOTICES

21.1 Any notice or payment required to be given to either party will be deemed to have been properly given and to be effective as of the date specified below if delivered to the respective address given below or to another address as designated by written notice given to the other party:
on the date of delivery if delivered in person;
on the date of mailing if mailed by first-class certified mail, postage paid; or
on the date of mailing if mailed by any global express carrier service that requires recipient to sign the documents demonstrating the delivery of such notice or payment.

In the case of Licensee: Cytori Therapeutics, Inc.
3020 Callan Rd.
San Diego, CA 92121
Attention: Mark Saad
Chief Financial Officer

In the case of The Regents: The Regents of the University of California
Office of Intellectual Property Administration
10920 Wilshire Blvd., Ste. #1200
Westwood, CA 90024
Attention: Director

22. ASSIGNABILITY

22.1 This Agreement may be assigned by The Regents, but is personal to Licensee and assignable by Licensee only with the written consent of The Regents, which consent will not be unreasonably withheld.

23. NO WAIVER

23.1 No waiver by either party of any default of this Agreement may be deemed a waiver of any subsequent or similar default. A suspension of duty under this Agreement due to force majeure will not be for a period longer than one (1) year.

24. FAILURE TO PERFORM

24.1 If either party finds it necessary to undertake legal action against the other on account of failure of performance due under this Agreement, then the prevailing party is entitled to reasonable attorney's fees in addition to costs and necessary disbursements.

25. GOVERNING LAWS

25.1 THIS AGREEMENT WILL BE INTERPRETED AND CONSTRUED IN ACCORDANCE WITH THE LAWS OF THE STATE OF CALIFORNIA WITHOUT REGARD TO CONFLICT OF LAWS OR TO WHICH PARTY DRAFTED PARTICULAR PROVISIONS OF THIS AGREEMENT, but the scope and validity of any patent or patent application will be governed by the applicable laws of the country of the patent or patent application. Disputes between the parties regarding this Agreement will utilize only trial courts within California for disputes that go to court.

26. PREFERENCE FOR U.S. INDUSTRY

26.1 Because this Agreement grants the exclusive right to use or sell the Inventions in the U.S., Licensee agrees that any products sold in the U.S. embodying this Invention or produced through the use thereof will be manufactured substantially in the U.S.

27. GOVERNMENT APPROVAL OR REGISTRATION

27.1 Licensee will notify The Regents if it becomes aware that this Agreement is subject to any U.S. or foreign government reporting or approval requirement. Licensee will make all necessary filings and pay all costs including fees, penalties and all other out-of-pocket costs associated with such reporting or approval process.

28. EXPORT CONTROL LAWS

28.1 Licensee will observe all applicable U.S. and foreign laws with respect to the transfer of Product and related technical data to foreign countries, including, without limitation, the International Traffic in Arms Regulations (ITAR) and the Export Administration Regulations.

***29* SECRECY**

29.1 With regard to confidential information ("Data"), which can be oral or written or both, received from The Regents regarding this Inventions, Licensee agrees:

29.1.1 Not to use the Data except for the sole purpose of performing under the terms of this Agreement;

29.1.2 To safeguard Data against disclosure to others with the same degree of care as it exercises with its own data of a similar nature;

29.1.3 Not to disclose Data to others (except to its employees, agents or consultants who are bound to Licensee by a like obligation of confidentiality) without the express written permission of The Regents, except that Licensee is not prevented from using or disclosing any of the Data that:

(i) Licensee can demonstrate by written records was previously known to it;
(ii) is now or becomes in the future, public knowledge other than through acts or omissions of Licensee; or
(iii) is lawfully obtained by Licensee from sources independent of The Regents;
(iv) is required to be disclosed to a governmental entity or agency in connection with seeking any governmental or regulatory approval, or pursuant to the lawful requirement or request of a governmental entity or agency; and

29.1.4 that the secrecy obligations of Licensee with respect to Data will continue for a period ending five (5) years from the termination date of this Agreement.

29.2 Upon the termination of this Agreement, Licensee must destroy or return to The Regents any Data in its possession within thirty (30) days following the effective date of termination. However, Licensee may retain one copy of Data solely for archival purposes, provided that such Data is subject to the confidentiality provisions set forth in this Paragraph 29.2 (Secrecy). Within sixty (60) days following termination, Licensee must provide The Regents with a written notice that Data has been returned or destroyed.

29.3 With regard to biological material received by Licensee from The Regents, if any, including any cell lines, vectors, genetic material, derivatives, products progeny or material derived there from ("Biological Material"), Licensee agrees:

29.3.1 Not to use Biological Material except for the sole purpose of performing under the terms of this Agreement;

29.3.2 Not to transfer Biological Material to others (except to its employees, agents or consultants who are bound to Licensee by like obligations conditioning and restricting access, use and continued use of Biological Material) without the express written permission of The Regents, except that Licensee is not prevented from transferring Biological Material that:

(i) becomes publicly available other than through acts or omissions of Licensee; or

(ii) is lawfully obtained by Licensee from sources independent of The Regents; and

29.3.3 To safeguard Biological Material against disclosure and transmission to others with the same degree of care as it exercises with its own biological materials of a similar nature; and,

29.3.4 to destroy all copies of Biological Material at the termination of this Agreement.

30. MISCELLANEOUS

30.1 The headings of the several sections are inserted for convenience of reference only and are not intended to be a part of or to affect the meaning or interpretation of this Agreement.

30.2 This Agreement is not binding on the parties until it has been signed below on behalf of each party. It is then effective as of the Effective Date.

30.3 No amendment or modification of this Agreement is valid or binding on the parties unless made in writing and signed on behalf of each party.

30.4 This Agreement embodies the entire understanding of the parties and will supersede all previous communications, representations, or understandings, either oral or written, between the parties relating to the subject matter hereof.

30.5 In case any of the provisions contained in this Agreement is held to be invalid, illegal or unenforceable in any respect, that invalidity, illegality or unenforceability will not affect any other provisions of this Agreement and this Agreement will be construed as if the invalid, illegal or unenforceable provisions had never been contained in it.

30.6 None of the provisions of this Agreement is intended to create any form of joint venture between the parties, rights in third parties or rights that are enforceable by any third party.

IN WITNESS WHEREOF, both The Regents and Licensee have executed this Agreement, in duplicate originals, by their respective and duly authorized officers on the day and year written.

CYTORI THERAPEUTICS, INC	THE REGENTS OF THE UNIVERSITY OF CALIFORNIA
By: /s/ Christopher J. Calhoun	By: /s/ Emily Loughran
Name: Christopher J. Calhoun	Name: Emily Loughran
Title: CEO	Title: Director of Licensing
Date: September 18, 2006	Date: September 26, 2006

EXHIBIT 15.1

Letter Re Unaudited Interim Financial Information

November 14, 2006

Cytori Therapeutics, Inc.
3020 Callan Rd
San Diego, CA 92121

Re: Registration Statement Nos. 333-82074, 333-122691, and 333-134129

With respect to the subject registration statements, we acknowledge our awareness of the use therein of our report dated November 14, 2006 related to our review of interim financial information.

Pursuant to Rule 436 under the Securities Act of 1933 (the Act), such report is not considered part of a registration statement prepared or certified by an independent registered public accounting firm, or a report prepared or certified by an independent registered public accounting firm within the meaning of Sections 7 and 11 of the Act.

/s/ KPMG, LLP

San Diego, California

EXHIBIT 31.1

Certification of Chief Executive Officer Pursuant to
Securities Exchange Act Rule 13a-14(a)
As Adopted Pursuant to
Section 302 of the Sarbanes-Oxley Act of 2002

I, Christopher J. Calhoun, the Chief Executive Officer of Cytori Therapeutics, Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Cytori Therapeutics, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

(a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 14, 2006
/s/ Christopher J. Calhoun
Christopher J. Calhoun,
Chief Executive Officer

EXHIBIT 31.2

Certification of Chief Financial Officer Pursuant to
Securities Exchange Act Rule 13a-14(a)
As Adopted Pursuant to
Section 302 of the Sarbanes-Oxley Act of 2002

I, Mark E. Saad, the Chief Financial Officer of Cytori Therapeutics, Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Cytori Therapeutics, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

(a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 14, 2006
/s/ Mark E. Saad
Mark E. Saad,
Chief Financial Officer

EXHIBIT 32.1

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350/ SECURITIES EXCHANGE ACT RULE 13a-14(b), AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES - OXLEY ACT OF 2002

In connection with the Quarterly Report on Form 10-Q of Cytori Therapeutics, Inc. for the quarterly period ended September 30, 2006 as filed with the Securities and Exchange Commission on the date hereof, Christopher J. Calhoun, as Chief Executive Officer of Cytori Therapeutics, Inc., and Mark E. Saad, as Chief Financial Officer of Cytori Therapeutics, Inc., each hereby certifies, respectively, that:

1. The Form 10-Q report of Cytori Therapeutics, Inc., that this certification accompanies fully complies with the requirements of section 13(a) of the Securities Exchange Act of 1934.

2. The information contained in the Form 10-Q report of Cytori Therapeutics, Inc., that this certification accompanies fairly presents, in all material respects, the financial condition and results of operations of Cytori Therapeutics, Inc.

By: /s/ Christopher J. Calhoun

Dated: November 14, 2006

Christopher J. Calhoun
Chief Executive Officer

By: /s/ Mark E. Saad

Dated: November 14, 2006

Mark E. Saad
Chief Financial Officer