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, 2005

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 an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes o No ☒

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, 2005, there were 15,249,783 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 of
Cytori Therapeutics, Inc.:

We have reviewed the consolidated condensed balance sheet of Cytori Therapeutics, Inc. (formerly MacroPore Biosurgery, Inc.) and subsidiaries (the Company) as of September 30, 2005, the related consolidated condensed statements of operations and comprehensive income (loss) for the three-month and nine-month periods ended September 30, 2005 and 2004, and the related consolidated condensed statements of cash flows for the nine-month periods ended September 30, 2005 and 2004. These consolidated condensed financial statements are the responsibility of the Company's management.

We conducted our reviews 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 reviews, 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, 2004, and the related consolidated statements of operations and comprehensive income (loss), stockholders' equity, and cash flows for the year then ended (not presented herein); and in our report dated March 11, 2005, 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, 2004, 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, 2004 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 11, 2005, includes an explanatory paragraph referring to the matter in note 1 of those consolidated 'financial statements.

(signed) KPMG LLP

San Diego, California
November 14, 2005

CYTORI THERAPEUTICS, INC.
CONSOLIDATED CONDENSED BALANCE SHEETS

	As of September 30, 2005 (Unaudited)	As of December 31, 2004
Assets		
Current assets:		
Cash and cash equivalents	$ 2,275,000	$ 2,840,000
Short-term investments, available-for-sale	7,284,000	10,579,000
Accounts receivable, net of allowance for doubtful accounts of $9,000 and $8,000 in 2005 and 2004, respectively	883,000	863,000
Inventories, net	262,000	379,000
Other current assets	784,000	984,000
Total current assets	11,488,000	15,645,000
Property and equipment, net	3,044,000	3,080,000
Other assets	318,000	236,000

Intangibles, net	1,920,000	2,122,000
Goodwill	4,387,000	4,387,000
Total assets	$ 21,157,000	$ 25,470,000
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable and accrued expenses	$ 3,975,000	$ 2,329,000
Current portion of long-term obligations	689,000	938,000
Total current liabilities	4,664,000	3,267,000
Deferred gain on sale of assets	—	5,650,000
Deferred license fee revenue	1,500,000	1,500,000
Deferred development revenue	1,072,000	1,092,000
Option liability	1,170,000	—
Deferred other	7,811,000	—
Long-term obligations, less current portion	658,000	1,128,000
Total liabilities	16,875,000	12,637,000
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $0.001 par value; 5,000,000 shares authorized; -0- shares issued and outstanding in 2005 and 2004	—	—
Common stock, $0.001 par value; 95,000,000 shares authorized; 18,122,617 and 16,820,018 shares issued and 15,249,783 and 13,947,184 shares outstanding in 2005 and 2004, respectively	18,000	17,000
Additional paid-in capital	78,350,000	74,737,000
Accumulated deficit	(63,649,000)	(51,475,000)
Treasury stock, at cost	(10,414,000)	(10,414,000)
Accumulated other comprehensive loss	(23,000)	(32,000)
Total stockholders' equity	4,282,000	12,833,000
Total liabilities and stockholders' equity	$ 21,157,000	$ 25,470,000

SEE NOTES TO UNAUDITED CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2005	2004	2005	2004
Revenues:				
Sales to related party	$ 1,544,000	$ 298,000	$ 4,776,000	$ 3,113,000
Sales to third parties	2,000	1,189,000	6,000	2,166,000
Research grant	25,000	129,000	110,000	229,000
Development	11,000	158,000	20,000	158,000
	1,582,000	1,774,000	4,912,000	5,666,000
Cost of revenues:				
Cost of revenues, including stock based compensation expense of $0 for the three months ended September 30, 2005 and 2004, respectively; $0 and $3,000 for the nine months ended September 30, 2005 and 2004, respectively	796,000	1,184,000	2,233,000	2,375,000
Inventory provision	132,000	—	178,000	242,000
Gross profit	654,000	590,000	2,501,000	3,049,000
Operating expenses:				
Research and development, excluding stock based compensation expense of $116,000 and $0 for the three months ended September 30, 2005 and 2004, respectively; $179,000 and $32,000 for the nine months ended September 30, 2005 and 2004, respectively	4,680,000	2,959,000	11,549,000	8,134,000
Sales and marketing, excluding stock based compensation expense of $113,000 and $0 for the three months ended September 30, 2005 and 2004, respectively; $113,000 and $22,000 for the nine months ended September 30, 2005 and 2004, respectively	366,000	454,000	1,094,000	2,066,000

General and administrative, excluding stock based compensation expense of $112,000 and $0 for the three months ended September 30, 2005 and 2004, respectively; $112,000 and $71,000 for the nine months ended September 30, 2005 and 2004, respectively	2,212,000	1,502,000	6,219,000	4,303,000
Stock based compensation (excluding cost of revenues stock based compensation)	341,000	—	404,000	125,000
Change in fair value of option liability	924,000	—	984,000	—
Restructuring charge	—	37,000	—	107,000
Total operating expenses	8,523,000	4,952,000	20,250,000	14,735,000
Operating loss	(7,869,000)	(4,362,000)	(17,749,000)	(11,686,000)
Other income (expense):				
Gain on sale of assets	5,526,000	—	5,526,000	—
Gain on sale of assets, related party	—	8,883,000	—	13,883,000
Interest income	99,000	68,000	208,000	180,000
Interest expense	(31,000)	(44,000)	(107,000)	(131,000)
Other income (expense), net	(13,000)	1,000	(52,000)	(20,000)
Total other income (expense)	5,581,000	8,908,000	5,575,000	13,912,000
Net income (loss)	(2,288,000)	4,546,000	(12,174,000)	2,226,000
Other comprehensive income (loss) - unrealized holding income (loss)	(5,000)	9,000	9,000	(41,000)
Comprehensive income (loss)	$ (2,293,000)	$ 4,555,000	$ (12,165,000)	$ 2,185,000
Net income (loss) per common share:				
Basic	$ (0.15)	$ 0.33	$ (0.84)	$ 0.16
Diluted	$ (0.15)	$ 0.31	$ (0.84)	$ 0.15
Weighted average common shares:				
Basic	15,177,020	13,929,326	14,512,898	13,929,895
Diluted	15,177,020	14,661,303	14,512,898	14,779,478

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, 2005	2004
Cash flows from operating activities:		
Net (loss) income	$ (12,174,000)	$ 2,226,000
Adjustments to reconcile net (loss) income to net cash used in operating activities:		
Depreciation and amortization	1,290,000	1,302,000
Inventory provision	178,000	242,000
Increase (reduction) in allowance for doubtful accounts	1,000	(46,000)
Change in fair value of option liability	984,000	—
Amortization of gain on sale of assets	—	(735,000)
Amortization of gain on sale of assets, related party	—	(156,000)
Gain on sale of assets	(5,526,000)	—
Gain on sale of assets, related party	—	(13,883,000)
Stock based compensation	404,000	119,000
Increases (decreases) in cash caused by changes in operating assets and liabilities:		
Accounts receivable	(21,000)	1,159,000
Inventories	(61,000)	(47,000)
Other current assets	200,000	(414,000)
Other assets	(206,000)	18,000
Accounts payable and accrued expenses	1,646,000	(515,000)
Deferred license fee revenue	—	1,500,000
Deferred development revenue	(20,000)	(158,000)
Net cash used in operating activities	(13,305,000)	(9,388,000)
Cash flows from investing activities:		
Proceeds from sale and maturity of short-term investments	36,788,000	38,221,000
Purchases of short-term investments	(33,484,000)	(40,805,000)

Proceeds from sale of assets, net	—	6,934,000
Proceeds from sale of assets, related party	—	6,500,000
Purchases of property and equipment	(1,052,000)	(673,000)
Acquisition costs	—	(28,000)
Net cash provided by investing activities	2,252,000	10,149,000
Cash flows from financing activities:		
Principal payments on long-term obligations	(719,000)	(608,000)
Proceeds from long-term obligations	—	1,039,000
Proceeds from exercise of employee stock options and warrants	207,000	26,000
Proceeds from sale of common stock	3,003,000	—
Proceeds from issuance of options	186,000	—
Proceeds received in excess of fair market value of common stock	7,811,000	—
Purchase of treasury stock	—	(1,052,000)
Net cash provided by (used in) financing activities	10,488,000	(595,000)
Net (decrease) increase in cash and cash equivalents	(565,000)	166,000
Cash and cash equivalents at beginning of period	2,840,000	2,820,000
Cash and cash equivalents at end of period	$ 2,275,000	$ 2,986,000
Supplemental disclosure of cash flows information:		
Cash paid during period for:		
Interest	$ 112,000	$ 133,000
Taxes	16,000	7,000

SEE NOTES TO UNAUDITED CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

CYTORI THERAPEUTICS, INC.
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
SEPTEMBER 30, 2005
(UNAUDITED)

1. Basis of Presentation

Our accompanying unaudited consolidated condensed financial statements as of September 30, 2005 and for the three and nine months ended September 30, 2005 and 2004 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, 2004 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., formerly known as MacroPore Biosurgery, Inc., have been included. Operating results for the three and nine months ended September 30, 2005 are not necessarily indicative of the results that may be expected for the year ending December 31, 2005. For further information, refer to our consolidated financial statements for the year ended December 31, 2004 and footnotes thereto which were included in our Annual Report on Form 10-K, dated March 31, 2005. Certain prior period amounts have been reclassified to conform to current period presentation.

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, determining the warranty provision, evaluating for goodwill impairment, and the accounting for product line dispositions.

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 reporting our financial results in two segments. As a result of the aforementioned reorganization, our name has been changed from MacroPore Biosurgery, Inc. to Cytori Therapeutics, Inc.

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. MacroPore Biosurgery manufactures and distributes the HYDROSORB™ family of FDA-cleared bioresorbable spine

and orthopedic implants; it also develops the Thin Film bioresorbable implants for Senko Medical Trading Co. (“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 operating loss for each segment, we used the same accounting policies as those used for our consolidated company and as described in Note 1 to our consolidated financial statements for the year ended December 31, 2004. However, segment operating results exclude allocations of company-wide general and administrative costs, changes in fair value of our option liability, and any restructuring charges.

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:

	Three months ended September 30,		Nine months ended September 30,	
	2005	2004	2005	2004
Revenues:				
Regenerative cell technology	$ 27,000	$ 131,000	$ 116,000	$ 237,000
MacroPore Biosurgery	1,555,000	1,643,000	4,796,000	5,429,000
Total Revenues	$ 1,582,000	$ 1,774,000	$ 4,912,000	$ 5,666,000
Segment losses:				
Regenerative cell technology	$ (4,231,000)	$ (2,090,000)	$ (9,590,000)	$ (5,436,000)
MacroPore Biosurgery	(390,000)	(733,000)	(844,000)	(1,769,000)
General and administrative expenses	(2,324,000)	(1,502,000)	(6,331,000)	(4,374,000)
Changes in fair value of option liability	(924,000)	—	(984,000)	—
Restructuring charge	—	(37,000)	—	(107,000)
Total operating loss	$ (7,869,000)	$ (4,362,000)	$ (17,749,000)	$ (11,686,000)

	As of September 30, 2005	As of December 31, 2004
Assets:		
Regenerative cell technology	$ 7,805,000	$ 7,795,000
MacroPore Biosurgery	3,148,000	3,457,000
Corporate assets	10,204,000	14,218,000
Total assets	$ 21,157,000	$ 25,470,000

4. Stock Based Compensation

We apply the intrinsic value-based method of accounting 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” to account for our employee stock option plans. Under the intrinsic value method, compensation expense is recognized only if the current market price of the underlying stock exceeds the exercise price as of the measurement date (typically the date of grant). Any resulting expense is recorded on a straight-line basis over the applicable vesting period. Statement of Financial Accounting Standards (“SFAS”) 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 No. 123, we have elected to continue to apply the intrinsic value-based method of accounting described above, and have adopted the disclosure requirements of SFAS No. 123, as amended by SFAS No. 148, “Accounting for Stock-Based Compensation—Transition and Disclosure.”

The pro forma effects of stock-based compensation on net income (loss) and net income (loss) per common share have been estimated using a grant date fair value model (Black-Scholes option-pricing model).

The Black-Scholes option-pricing model was developed for use in estimating the fair value of traded options that have no restrictions and are fully transferable and negotiable in a free trading market. Black-Scholes does not consider the employment, transfer or vesting restrictions that are inherent in our employee options. Use of an option valuation model, as required by SFAS No. 123, includes subjective assumptions based on long-term predictions, including the expected stock price volatility and average life of each option grant. Because our employee stock options have characteristics different from those of freely traded options, and because the assumptions underlying the Black-Scholes model involve substantial judgment, our estimate of the fair value of our awarded stock options may differ from the ultimate value realized by the recipient employee.

No stock options were granted during the three months ended September 30, 2005 and 2004; however awards previously granted to an employee were modified during the three months ended September 30, 2005 (see note 19). The estimated weighted average grant date fair values of stock options granted during the nine months ended September 30, 2005 and 2004, were $2.27 and $3.26 per share, respectively. Fair value under SFAS No. 123 is determined using the Black-Scholes option-pricing model with the following assumptions:

	For the three months ended September 30,		For the nine months ended September 30,	
	2005	2004	2005	2004
Expected term	—	—	6 years	7 years
Interest rate	—	—	3.97%	3.31-4.35%
Volatility	—	—	81.54%	86.4-89.3%
Dividends	—	—	—	—

Had compensation expense been recognized for stock-based compensation plans in accordance with SFAS No. 123, we would have recorded the following net income (loss) and net income (loss) per share amounts:

	For the three months ended September 30,		For the nine months ended September 30,	
	2005	2004	2005	2004
Net income (loss):				
As reported	$ (2,288,000)	$ 4,546,000	$ (12,174,000)	$ 2,226,000
Add: Employee stock based compensation expense included in reported net loss, net of related tax effects	341,000	—	341,000	96,000
Deduct: Total employee stock based compensation expense determined under the fair value method for all awards, net of related tax effects	(551,000)	(764,000)	(1,968,000)	(1,991,000)
Pro forma	$ (2,498,000)	$ 3,782,000	$ (13,801,000)	$ 331,000
Basic income (loss) per common share:				
As reported	$ (0.15)	$ 0.33	$ (0.84)	$ 0.16
Pro forma	$ (0.16)	$ 0.27	$ (0.95)	$ 0.02
Diluted income (loss) per common share:				
As reported	$ (0.15)	$ 0.31	$ (0.84)	$ 0.15
Pro forma	$ (0.16)	$ 0.26	$ (0.95)	$ 0.02

The pro forma compensation expense may not be representative of such expense in future years.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), “Share-based Payment” (“FAS 123R”). As affected by Securities and Exchange Commission Release No. 33-8568, “Amendment to Rule 4-01(a) of Regulation S-X Regarding the Compliance Date for Statement of Financial Accounting Standards No. 123 (Revised 2004), Share-Based Payment”, FAS 123R is effective for annual periods beginning after June 15, 2005 (January 1, 2006 for us).

FAS 123R will require all share-based payment transactions, including those with employees, to be measured at fair value. Moreover, the fair value of share-based payment awards (including employee stock option grants) will be recognized as expense in the statements of operations over the requisite service period of each award. FAS 123R also changes the manner in which deferred taxes are recognized on share-based payment awards, as well as the accounting for award modifications.

The adoption of FAS 123R will have a material effect on our results of operations. Based on pro forma amounts for historical periods presented earlier in this note, our reported net loss will increase (or our net income will be reduced) each quarterly period once FAS 123R has been adopted.

5. 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 have evaluated our investments in accordance with the provisions of SFAS No. 115, “Accounting for Certain Investments in Debt and Equity Securities.” Based on such evaluation, our management has determined that all of our investment securities are properly classified as available-for-sale. Based on our intent, our investment policies and our ability to liquidate debt securities, we classify such short-term investment securities within current assets. Available-for-sale securities are carried at fair value, with unrealized gains and losses reported as a separate component of stockholders’ equity as accumulated other comprehensive income (loss). 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 realized gains and losses are recorded as a component within other income (expense).

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 if 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, 2005, the excess of historical cost over the fair value of our short-term investments is immaterial.

6. 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.

During the third quarter of 2005, we recorded a provision of $132,000, primarily for excess HYDROSORB™ inventory not related to the MYSTIQUE™ product line. The inventory was produced in anticipation of stocking orders from Medtronic which have not materialized. We determined it is more likely than not that the inventory will not be recovered. The provision has been charged to cost of sales in the third quarter and

will be maintained in a reserve account. A similar provision, for approximately $46,000, was recorded in the second quarter of 2005. The total inventory reserve balance as of September 30, 2005, is $178,000.

During the first quarter of 2004, we recorded a provision of approximately $242,000 for excess inventory. Such excess inventory was produced in consideration of our responsibility to be a back-up supplier for the craniomaxillofacial ("CMF") product line. We sold the assets related to this product line to an affiliate of Medtronic on September 30, 2002. In April of 2004, Medtronic indicated that it would no longer purchase CMF inventory from us under the back-up supply arrangement, leading to the determination that the remaining CMF inventory on hand would not be recoverable.

7. 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 future 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 nine months ended September 30, 2005 and 2004, we had no impairment losses associated with our long-lived assets.

8. Revenue Recognition

Product Sales

We sell our MacroPore Biosurgery products to distributors and, prior to the sale of our Thin Film product line in May 2004 (see note 15), also sold products directly to hospitals. We have agreements with our distributors wherein title and risk of loss pass upon shipment of the products to the distributor. Revenue is recognized upon shipment of products to distributors following receipt and acceptance of a distributor's purchase order. Before the sale of the Thin Film product line in May 2004, revenue from sales to hospitals was recognized upon delivery of the product.

Any upfront payments received from license/distribution agreements are recognized as revenues ratably over the period in which the customer benefits from the license/distribution agreement. Any recognized amounts are reported as sales to related party or sales to third parties depending upon the counterparty to the transaction.

On occasion, we offer extended payment terms to customers. 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 to our customers. We have recorded a reserve for the estimated costs we may incur under our warranty program (see Note 9).

The majority of our revenues are from Medtronic, 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 the statement of operations.

In September 2002, we entered into various agreements with Medtronic and a subsidiary of Medtronic for the sale of our CMF product line (see Note 17). The net proceeds received were recorded as deferred gain on sale of assets, related party. As part of the sale agreement, we agreed to act as a back-up supplier to Medtronic until Medtronic could integrate the acquired CMF assets into its manufacturing operations. The back-up supply agreement required that we sell CMF products ordered by Medtronic at our manufacturing cost. In the first and second quarters of 2004, we recognized a portion of the deferred gain upon the sale of CMF products to Medtronic under our back-up supply arrangement. The amount of the deferred gain recognized was equal to the excess of (a) the fair value of products sold, based on historical selling prices of similar products, over (b) our manufacturing cost. The residual portion of the deferred gain on sale of assets was fully recognized in the third quarter of 2004.

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 Biosurgery AG, a Swiss corporation ("MAST") and a subsidiary of MAST. Specifically, we retained the rights to develop and market Thin Film products in Japan (see Note 16).

In addition to transferring certain assets to MAST, we agreed to perform the following under the sale agreement:

- For a period of up to one year after the closing date, provide up to 300 hours of training to MAST representatives in all aspects of the manufacturing process related to the transferred Thin Film product line,
- For a period of up to one year after the closing date, act as a back-up supplier to MAST, and provide, in almost all cases, such product at our manufacturing cost, and
- For a period of up to one year after the closing date, supply or cause its suppliers to provide MAST with specified raw material at our cost.

Because of these additional performance requirements, we did not initially recognize any gain on sale of the Thin Film assets in the accompanying statement of operations. Instead, we initially recorded the net proceeds as deferred gain on sale of assets in the accompanying balance sheet.

The back-up supply agreement required that we sell most Thin Film products ordered by MAST at our manufacturing cost. In the second and third quarters of 2004, we recognized a portion of the deferred gain as revenue upon the sale of Thin Film assets to MAST under our back-up supply arrangement. The amount of the deferred gain recognized was equal to the excess of (a) the fair value of products sold, based on historical selling prices of similar products, over (b) our manufacturing cost. The residual portion of the deferred gain on sale of assets was fully recognized in the third quarter of 2005 (see Note 15).

Research

We earn revenue for performing tasks under research agreements with both commercial enterprises and governmental agencies like the National Institutes of Health ("NIH"). Milestone payments are considered to be payments received for the accomplishment of a discrete, substantive earnings event. The

non-refundable payment arising from the achievement of a defined milestone is recognized as revenue when the following performance criteria for that milestone have been met:

- Substantive effort was required to achieve the milestone,
- The amount of the milestone payments appears reasonably commensurate with the effort expended, and
- Collection (or retention) of the payment is reasonably assured.

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.

Revenue earned under development agreements is classified as research grant or development revenues in our statements of operations, depending on the nature of the arrangement. The costs associated with development agreements are recorded as research and development expense.

We recognized NIH grant revenue of $25,000 and $110,000 for the three and nine months ended September 30, 2005, respectively, which includes allowable grant fees as well as cost reimbursements. In the three months and nine months ended September 30, 2005, we incurred qualifying costs of $25,000 and $108,000 respectively. In the three months and nine months ended September 30, 2004, we recognized NIH grant revenue of $129,000 and $229,000 and incurred qualifying expenditures of $93,000 and $246,000, respectively.

In the three and nine months ended September 30, 2005, we recognized development revenue of $11,000 and $20,000 and incurred costs of $24,000 and $91,000, respectively. In the three and nine months ended September 30, 2004, we recognized development revenue of $158,000 and incurred costs of $134,000.

9. 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 our warranty reserve at September 30, 2005 and 2004:

	As of January 1,	Additions-charges to expenses	Claims	As of September 30,
2005:				
Warranty reserve	$ 102,000	$ 40,000	$ —	$ 142,000
2004:				
Warranty reserve	$ 267,000	$ 66,000	$ (251,000)	$ 82,000

In August 2003, as part of our ongoing product monitoring process, we determined that some of the products sold to Medtronic did not meet certain expectations, based on criteria we previously communicated to Medtronic. We agreed to a “no charge” replacement of the affected inventory in the possession of Medtronic. In the nine months ended September 30, 2004, we incurred claims of $251,000 related to the replacement of this product. In the nine months ended September 30, 2005, we incurred no claims related to the replacement of this product.

10. Income Taxes

In all periods presented in these condensed consolidated financial statements, there was no provision or benefit for income taxes recorded due to our accumulated net loss position and the recognition of a full valuation allowance against deferred tax assets. There were also no components of current or deferred federal or state income tax provisions recorded for the periods presented.

11. Income (Loss) Per Share

We compute income (loss) per share based on the provisions of SFAS No. 128, “Earnings Per Share.” Basic per share data is computed by dividing income (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 (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 income (loss) per share attributable to common stockholders for the three and nine months ended September 30, 2005 and 2004 as their inclusion would be antidilutive. Potentially dilutive common shares excluded from the calculations of diluted income (loss) per share were 4,538,077 and 2,771,777 for the three and nine months ended September 30, 2005, respectively, and 2,221,478 and 2,296,978 for the three and nine months ended September 30, 2004, respectively.

Additionally, potential common shares excluded from per share calculations due to exercise prices that exceeded average market values were 3,008,999 and 4,775,299 for the three and nine months ended September 30, 2005, respectively, and 2,901,499 and 2,825,999 for the three and nine months ended September 30, 2004, respectively. Potential common shares in 2005 include an option to purchase 2,200,000 shares related to the Olympus equity agreement (see Note 18).

12. Commitments and Contingencies

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

Years Ending December 31,	Operating Leases
For the remainder of 2005	$ 500,000
2006	1,918,000
2007	1,924,000
2008	1,556,000
2009	1,383,000
2010	707,000
Total	$ 7,988,000

Rent expense for the three and nine months ended September 30, 2005, was $492,000 and $996,000, respectively. Rent expense for the three and nine months ended September 30 2004, was $185,000 and $597,000, respectively.

On May 24, 2005, we entered into a new lease for 91,000 square feet located at 3020 and 3030 Callan Road, San Diego, California. We intend to move the majority of our operations to this new facility over the next year. 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. In addition, we are committed to providing a minimum of $837,000 in agreed-upon leasehold improvements to the facility, which are not reflected in the table of contractual obligations shown above. As of September 30, 2005, we have made $80,000 in improvements to the facility.

During the fourth quarter of 2004, a lawsuit was filed by the University of Pittsburgh seeking a determination that its assignors, rather than the University of California's assignors, are the true inventors of U.S. Patent No. 6,777,231. Although we are not litigants and are not responsible for any settlement costs, we expect to incur additional legal expenses in connection with this lawsuit. If the University of Pittsburgh wins the lawsuit, our license rights to this patent could be rendered non-exclusive or nullified with respect to any third party that might license rights from the University of Pittsburgh, and our regenerative cell strategy could be adversely affected. As of September 30, 2005, we have accrued approximately $527,000 of litigation costs related to this lawsuit.

13. Long-term Debt

As of September 30, 2005 the future contractual principal payments, for the remainder of 2005 and subsequent years, on all of our promissory notes are as follows:

2005	$ 217,000
2006	614,000
2007	427,000
2008	89,000
Total	$ 1,347,000

14. Composition of Certain Financial Statement Captions

Inventories

	September 30, 2005 (Unaudited)	December 31, 2004
Raw materials	$ 125,000	$ 189,000
Finished goods	137,000	190,000
	$ 262,000	$ 379,000

Other Current Assets

	September30, 2005 (Unaudited)	December 31, 2004
Prepaid expenses	$ 670,000	$ 809,000
Accrued interest receivable	95,000	121,000
Other receivables	19,000	54,000
	$ 784,000	$ 984,000

Property and Equipment, net

	September 30, 2005 (Unaudited)	December 31, 2004
Manufacturing and development equipment	$ 4,529,000	$ 3,928,000
Office and computer equipment	2,541,000	2,186,000
Leasehold improvements	2,059,000	1,963,000
	9,129,000	8,077,000
Less accumulated depreciation and amortization	(6,085,000)	(4,997,000)

	$ 3,044,000	$ 3,080,000

Intangibles, net

	September 30, 2005 (Unaudited)	December 31, 2004
Stembanking technology	$ 960,000	$ 960,000
Intellectual property related to core regenerative technology	1,735,000	1,735,000
	2,695,000	2,695,000
Less accumulated amortization	(775,000)	(573,000)
	$ 1,920,000	$ 2,122,000

The amortization expense of intangibles for the three and nine months ended September 30, 2005 and 2004 was $67,000 and $202,000, respectively.

Estimated amortization of intangibles for the balance of 2005 and the years ended:

2005	$ 68,000
2006	270,000
2007	270,000
2008	270,000
2009	270,000
Thereafter	772,000
	$ 1,920,000

Accounts Payable and Accrued Expenses

	September 30, 2005 (Unaudited)	December 31, 2004
Accounts payable	$ 535,000	$ 481,000
Accrued bonus	611,000	472,000
Accrued vacation	616,000	579,000
Accrued expenses	636,000	470,000
Accrued accounting and legal fees	989,000	135,000
Accrued rent expense	446,000	90,000
Warranty reserve (Note 9)	142,000	102,000
	$ 3,975,000	$ 2,329,000

15. 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 Notes 8 and 16). 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.

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 16) 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 would 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 noted above, the settlement agreement does not cover claims associated with the territory of Japan. It is possible that either or both parties could re-assert such claims.

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.

16. Thin Film Japan Distribution Agreement

In the third quarter of 2004, we entered into a Distribution Agreement with Senko Medical Trading Co. ("Senko"). Under this agreement, we granted to Senko an exclusive license to sell and distribute certain Thin Film products in Japan.

At the inception of this arrangement, we received a $1,500,000 license fee that was recorded as deferred license fee revenue in the accompanying balance sheet. No portion of this license fee has been recognized in the statements of operations during any periods covered by these financial statements. We will recognize the deferred license fee as revenue systematically over the term of the Distribution Agreement once "commercialization" has been achieved. 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"). The Distribution Agreement contains certain provisions that could require us to return a portion of the upfront license fee. For instance, if it is determined in good faith by both Senko and us that commercialization of the Thin Film product is unobtainable, then 50% of the $1,500,000 license fee will be returned to Senko. Also, if we terminate the Distribution Agreement at any time within the initial three years post-commercialization, for any reason except for material breach by Senko, then a pro-rata share of the license fee will be returned to Senko. In no event will we recognize deferred license fee in the statement of operations if this would cause the remaining deferred income balance to fall below the amount that we potentially would have to refund to Senko.

We have earned or will be entitled to earn additional payments under the Distribution Agreement based on achieving the following defined milestones:

- Upon the notification to Senko of completion of the initial regulatory application to the MHLW for the Thin Film product, we are entitled to a nonrefundable payment of $1,250,000. We notified Senko of the completion of the regulatory application in September 2004, received payment in October 2004, and recorded deferred development revenue of $1,250,000. Of the amount deferred, we have recognized cumulative development revenues of $178,000, 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.
- Upon the achievement of commercialization, we are entitled to a nonrefundable payment of $250,000.

As part of the Thin Film sales agreement (see Notes 8 and 15), we granted MAST a right to acquire our Thin Film-related interest in Japan (the "Purchase Right") at 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 June 1, 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.

If MAST exercises the Purchase Right, we both may become obligated to reimburse each other for certain costs we have respectively incurred or will incur related to product development and protection of intellectual property rights in Japan.

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 payments in the nature of royalties, 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.

17. Gain on Sale of Assets, Related Party

In January 2004, we received a $5,000,000 milestone payment from Medtronic relating to the 2002 disposition of our CMF product line. As part of the disposition arrangement, we had agreed to complete clinical research regarding Faster Resorbable Polymers, an area that directly relates to the CMF product line transferred to Medtronic. We became entitled to the $5,000,000 payment after fulfilling the research requirements set out in the CMF sale agreement. The $5,000,000 payment was recognized during the first half of 2004 as gain on sale of assets, related party in the accompanying statement of operations.

During the third quarter of 2004, we completed all remaining performance obligations related to the 2002 sale of the CMF product line to Medtronic. Accordingly, we recorded $7,383,000 as a component of gain on sale of assets, related party, in the accompanying consolidated condensed statement of operations, representing the remaining balance that had theretofore been reported as deferred gain on sale of assets, related party.

Pursuant to the sale of the CMF product line, we were obliged to transfer certain "know-how," including manufacturing processes, patents, and other intellectual property, to Medtronic. If such know-how was transferred within a certain time frame defined in the CMF Asset Purchase Agreement dated September 30, 2002 (the "APA"), we would become entitled to a $2,000,000 milestone payment.

In the second quarter of 2004, we provided notice to Medtronic that the requisite know-how associated with the transferred CMF product line had been transferred, pursuant to the terms of, and within the timeframe specified by, the APA. Medtronic did not agree that know-how transfer had been completed and asserted that, in any case, that the maximum payment due to us was $1,000,000 rather than $2,000,000.

To avoid the risk and expense of arbitration, in the third quarter of 2004 we agreed to accept a negotiated settlement with Medtronic in the amount of $1,500,000 related to the know-how transfer. The $1,500,000 payment has been recognized as gain on sale of assets, related party in the statement of operations for the third quarter of 2004.

18. Olympus Equity Investment and Potential Strategic Alliance

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

Under this agreement, we distributed 1,100,000 newly issued shares of common stock to Olympus. We reflected the common stock issued to Olympus 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). As of September 30, 2005, Olympus held approximately 7.2% of our issued and outstanding shares.

We also granted Olympus an immediately exercisable option to acquire 2,200,000 shares of our stock on or before December 31, 2006. The exercise price of the option shares is $10 per share. We have accounted for this grant as a liability in accordance with Emerging Issues Task Force Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock". The 2,200,000 share option has been classified as a liability because from the date of grant through the expiration, we are required to deliver listed common stock to settle the option shares upon exercise. Accordingly, the fair value of the 2,200,000 share option has been (and will continue to be) re-measured at the end of each reporting period, under the Black-Scholes option pricing-model, with movements in fair value reported in the statements of operations as change in fair value of option liability. At the time we entered into the Purchase Agreement, the contractual term, interest rate and volatility assumptions under the Black-Scholes option pricing model were 1.67 years, 3.46% and 59.7%, respectively. As of September 30, 2005 the contractual term, interest rate and volatility assumptions under the Black-Scholes option pricing model were 1.25 years, 4.10% and 64.21%, respectively.

The $11,000,000 in total proceeds we received exceeded the sum of the fair value of the option granted as well as the market price of our stock at the time the Olympus share purchase was agreed upon. The difference between the proceeds received and the fair values of our common stock and option liability has been recorded as deferred other on the accompanying balance sheet. This deferred other will be recharacterized in the future as events and circumstances dictate.

In November 2005, we entered in to a strategic business alliance with Olympus relating to our regenerative cell technology. Refer to Note 20 for more details.

Olympus has also been offered a seat on our Board of Directors, but has not yet exercised this right.

19. Termination of Chief Operating Officer's Employment

In August 2005, our Chief Operating Officer ("COO"), ceased employment with us. We paid the former COO a lump sum cash severance payment of $155,164 and have extended the post-separation exercise period for two years on 253,743 vested stock options. In addition to the cash severance payment we have recorded stock based compensation expense of $337,000 in the third quarter of 2005, which represents the intrinsic value of the options held by the COO at the date of the modification.

20. Subsequent Event

On November 4, 2005, we entered into a joint venture and other related agreements with Olympus (the "JV Agreements"). The JV Agreements were established to form a joint venture company, Olympus-Cytori, Inc., a Delaware corporation, that will be owned equally by the two companies. Olympus-Cytori, Inc. (the "Joint Venture"), will develop and manufacture future generation devices based on our Celution™ System. These devices will process and purify adult stem and regenerative cells residing in adipose tissue (also known as fat) for various therapeutic clinical applications. Research is ongoing and we believe that adult stem and regenerative cells may be an effective treatment for certain diseases.

Under the JV Agreements:

- Olympus will pay $30 million to the Joint Venture for its 50% interest therein, and will enter into a License/Joint Development Agreement with the Joint Venture and us to develop a second generation commercial therapeutic system

and manufacturing capabilities. Olympus will grant the Joint Venture a non-exclusive license to any Olympus intellectual property incorporated into the device, and will receive $8 million in prepaid fees from the Joint Venture to fund the development work.

- We will license on an exclusive and perpetual basis our therapeutic device technology, including the Celution™ System and certain related intellectual property, to the Joint Venture for use in future generation devices and will receive an initial $11 million payment and a 50% interest in the Joint Venture. Upon our receipt of a CE mark for the first generation Celution™ System (expected in the first half of 2006), we will also receive an $11 million development milestone payment from the Joint Venture. In addition, we will be required to use commercially reasonable efforts to obtain regulatory approval for the therapeutic use of the devices in the United States, Japan and Europe.

- The Joint Venture will have exclusive rights to our technology for the development, manufacture, and supply of the devices (second generation and beyond) for all therapeutic applications. The Joint Venture can sell the Celution™ Systems exclusively to us at a formula-based transfer price, and we will maintain marketing rights to the devices for all therapeutic applications of adipose stem and regenerative cells.

- Olympus owns approximately 7.2% of our outstanding common stock and holds an option to purchase up to 2.2 million additional shares at $10.00 per share through December 2006. If Olympus chooses to exercise that option, it would represent up to 19% ownership of our outstanding common stock. Additionally, Olympus has a right, which it has not yet exercised, to designate a director to serve on our Board of Directors.

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 this Management's Discussion and Analysis of Financial Conditions and Results of Operations.

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

We continue to invest in the preclinical development of our adipose stem and regenerative cell therapies, with the aim of advancing them into and through clinical trials. The indications we are focused on include cardiovascular disease, chronic wounds for gastrointestinal disorders, spinal disc repair, and aesthetic and reconstructive surgery.

To facilitate the processing and delivery of adipose stem and regenerative cells, we developed a proprietary point-of-care system, Celution™, to isolate and concentrate a patient's own stem and regenerative cells in real-time. Our goal is for the Celution™ system to be the ultimate commercial vehicle for our investigational cell therapies and which may be used universally across multiple applications. The commercialization model will be based on the sale of Celution™ devices and related single-use consumables.

On November 4, 2005, we entered into a strategic development and manufacturing joint venture among other agreements ("JV Agreements") with Olympus Corporation ("Olympus"). As part of the terms of the Agreement, we will form a joint venture, Olympus-Cytori, Inc. (the "Joint Venture"), to develop and manufacture future generation devices based on our Celution™ System.

The key provisions of the JV Agreements are as follows:

- We will license on an exclusive and perpetual basis our therapeutic device technology, including the Celution™ System and certain related intellectual property, to the Joint Venture and will receive an initial $11 million payment and a 50% interest in the Joint Venture;
- Upon our receipt of a CE mark for the first generation Celution™ System, we will receive a second $11 million development milestone payment from the Joint Venture;
- Olympus will pay $30 million to the Joint Venture for its 50% interest therein, and enter into a License/Joint Development Agreement with the Joint Venture and us to develop a second generation commercial therapeutic system and manufacturing capabilities. Olympus will grant the Joint Venture a non-exclusive license to any Olympus intellectual property incorporated into the device, and will receive $8 million in prepaid fees from the Joint Venture to fund its development work.
- The Joint Venture will have exclusive rights to our technology for the development, manufacture, and supply of the devices (second generation and beyond) for all therapeutic applications. The Joint Venture can sell the Celution™ Systems exclusively to us at a formula-based transfer price, and we will maintain marketing rights to the devices for all therapeutic applications of adipose stem and regenerative cells.

In addition to the JV Agreements, we entered into a definitive Common Stock Purchase Agreement with Olympus in May 2005. As part of that agreement, Olympus purchased 1.1 million shares, representing 7.2% of our outstanding common stock, and may exercise an option to purchase up to 2.2 million additional shares at $10.00 per share through December 2006. If Olympus chooses to exercise that option, it would represent up to 19% ownership of our outstanding common stock. Additionally, Olympus has a right, which it has not yet exercised, to designate a director to serve on our Board of Directors.

In August 2005, we announced the completion of the development of the first generation Celution™ system. We have since submitted the necessary regulatory applications for a CE Mark, which would provide regulatory clearance for the system in Europe. We expect to continue submitting regulatory applications for this system in the United States in 2006.

However, before we begin to realize appreciable product revenues from this system, we believe we will first need to successfully conduct controlled, randomized clinical trials in specific therapeutic areas to demonstrate the benefits of using adipose stem and

regenerative cells. In 2006, we intend to initiate clinical safety studies for our investigational adipose stem and regenerative cell therapies for treatment of ischemic heart disease in Europe, which may include myocardial infarction and/or congestive heart failure, as well as for applications in breast augmentation in Japan. Additionally, we continue to support preclinical research in indications both within and outside these areas.

As part of our growth strategy, we are seeking co-development partnerships with pharmaceutical, medical device or biotechnology companies for indications outside of cardiovascular disease. Additionally, we are seeking partners who can help identify drugs, proteins or genes that when combined with adipose stem and regenerative cells, enhance or stimulate certain select properties. For example, we may seek to identify a drug that when mixed with adipose stem and regenerative cells, directs specific cells to turn more quickly and efficiently into blood vessels or into new heart muscle in areas of a damaged heart. All of these potential partnerships could include up-front payments, milestone payments, licensing fees, and /or royalties on potential sales of products.

In addition to our regenerative cell technology operations, our MacroPore Biosurgery unit develops and manufactures innovative bioresorbable surgical implants. Certain cash flows that we may realize from MacroPore Biosurgery may be used to support our development of adipose stem and regenerative cell therapies.

Specifically, MacroPore Biosurgery manufactures the HYDROSORB™ family of FDA-cleared bioresorbable spine and orthopedic implants, which are distributed worldwide exclusively through Medtronic, Inc. ("Medtronic"). This product line has generated $4,776,000 in revenue to us for the first nine months of 2005. The vast majority of these revenues are related to initial stocking orders that Medtronic placed for the most recent addition to this product line, the MYSTIQUE™ radiographically identifiable cervical graft containment plate, which Medtronic began to market in the third quarter of 2005. We expect to continue filling MYSTIQUE™ stocking orders through the fourth quarter of 2005. At present, we do not have sufficient visibility of potential orders by Medtronic in 2006 for the HYDROSORB™ product line, including MYSTIQUE™, to provide an accurate range of revenue projections for 2006. Due to Medtronic's dwindling orders for non-MYSTIQUE™ products in the HYDROSORB™ family, we recorded an inventory provision of $46,000 and $132,000 in the second and third quarters of 2005, respectively.

Additionally, MacroPore Biosurgery is developing Thin Film bioresorbable implants exclusively for Senko Medical Trading Co. ("Senko"), which owns distribution rights exclusively for Japan.

Our intended research and development of our regenerative cell technology is expected to be very costly. We plan to fund it through:

- Cash from the November 2005 Joint Venture transaction with Olympus;
- Existing cash reserves;
- Potential future financings, including Olympus' option to purchase up to 2.2 million shares of our common stock at $10.00 per share;
- Potential research grants;
- Profits and cash flows, if any, from MacroPore Biosurgery; and
- Payments, if any, related to potential regenerative cell technology partnerships.

Olympus Equity Investment and Strategic Alliance

In the second quarter of 2005, we sold to Olympus, a global manufacturer of high-end medical devices, 1,100,000 newly issued shares of common stock at $10.00 per share. We also granted Olympus an option to acquire 2,200,000 additional shares of our stock on or before December 31, 2006. The exercise price of the option shares is $10 per share.

This equity agreement initially generated $11,000,000 in cash proceeds for us, which we will use to continue our development efforts related to our adipose stem cell technology.

We have accounted for the initial common stock purchase agreement as follows:

- We have reflected the common stock we issued to Olympus 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).

- We initially recognized the fair value of the 2,200,000 share option granted as a liability of $186,000 in accordance with Emerging Issues Task Force Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock", since at the time of grant and thereafter until the end of December 31, 2006, we are required to issue listed shares of common stock to settle these option shares if they are exercised by Olympus. Under EITF 00-19, the fair value of this option has been, and will continue to be, re-measured at the end of each subsequent reporting period, with movements in fair

value reported in the statements of operations as change in fair value of option liability. As of June 30, 2005 and September 30, 2005, the fair value and corresponding liability of the option have been measured at $246,000 and $1,170,000, respectively.

- The difference between the $11,000,000 proceeds received and the sum of the fair values of the common stock and initial option liability we issued has been recorded as deferred other. This deferred other will be characterized in the future as events and circumstances dictate.

In November 2005, we entered into a strategic development and manufacturing collaboration with Olympus, as described in more detail earlier in this Overview. We also will be entitled to receive an additional $11 million upon our receipt of a CE mark for the first generation Celution™ System, which is expected to occur in the first half of 2006. We may possibly receive even more proceeds if Olympus decides to exercise its option to purchase 2,200,000 shares of our common stock at a fixed price of $10.00 per share.

Disposition of Product Lines and Related Agreements

Sale of 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 and one of its subsidiaries for $7,000,000 in cash.

As part of the Thin Film disposition agreement, and for a period of up to one year, we were required to provide training to MAST representatives in all aspects of the manufacturing process related to the transferred Thin Film product line, and to act in the capacity of a back-up supplier to MAST. Under the back-up supply agreement, we agreed in nearly all cases to supply product ordered by MAST at our manufacturing cost.

Because of these and other additional performance requirements, we did not initially recognize any gain on sale of the Thin Film assets in our statement of operations. Instead, we initially recorded approximately $6,450,000 as deferred gain on sale in the balance sheet.

However, in 2004 we did recognize $772,000 of the deferred gain as revenues related to the sale of Thin Film products to MAST under the back-up supply agreement at cost. The recognition of the deferred gain was necessary in 2004 in order to state revenues at fair value of products sold, based on historical selling prices of similar products, over the Company's manufacturing cost. No deferred gain has been recognized as revenue in 2005 because there were no shipments of product to MAST.

Under the Thin Film sale agreement, we were potentially entitled to the following additional consideration (beyond the $7,000,000 cash payment received at closing), none of which was recognized in our 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 cash payment.

MAST did not remit to us the contingent $2,000,000 payment noted above.

Accordingly, 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. 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 that we have waived 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 (described in the section below) and Thin Film products are ultimately marketed in Japan, MAST would no longer be obliged to share gross profits and royalties with us, as originally contemplated in the MAST agreements.

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 would cooperate in the planning of such study. However, if MAST exercises the Purchase Right or we enter into a supply agreement with MAST related to the territory of Japan, we would be obligated to reimburse MAST for any Thin Film product

supplied in connection with the Japan study at a cost of $50 per sheet.

As noted above, the settlement agreement does not cover claims associated with the territory of Japan. It is possible that either or both parties could re-assert such claims.

As a result of the settlement agreement described above, we recognized the deferred gain as gain on sale of assets of $5,650,000, less $124,000 of related deferred costs, in the third quarter of 2005.

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 in the next section), 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 deferred license fee revenue 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.

Accordingly, we will begin to recognize this $1,500,000 license fee as revenues only after commercialization has been achieved. Moreover, we will not recognize all of the revenues at one time – instead, we will reflect the fee in revenues on a systematic basis over the expected period of time we anticipate that Senko will benefit from the arrangement. However, we will not recognize deferred license fee revenue in the statements of operations if this would cause the remaining deferred license fee revenue balance to fall below the amount that we potentially would have to refund to Senko. As of September 30, 2005, commercialization had not occurred; however, commercialization is expected in the fourth quarter of 2005 or early 2006.

Under the distribution agreement, we will also be entitled to earn additional payments from Senko based on achieving defined milestones. We will recognize such payments as revenues when the performance criteria for a milestone have been met, presuming that achievement of the milestone involves substantive effort and the fees received are commensurate with the level of effort expended. 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 deferred development revenue. Of the amount deferred, we have recognized a total of $178,000 ($20,000 and $158,000 in 2005 and 2004, respectively) as development revenues. The amount recognized as development revenues represents the relative fair value of the completed milestone as compared with the fair value of all milestones expected to be necessary to achieve regulatory approval by the MHLW.

The previously described sale agreement granted MAST a "Purchase Right" to acquire our Thin Film-related interests and rights for Japan at 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 June 1, 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.

If MAST exercises the Purchase Right, we both may become obligated to reimburse each other for certain costs we have respectively incurred or will incur related to product development and protection of intellectual property rights in Japan.

Sale of CMF Product Line

In September 2002, we entered into an Asset Purchase Agreement (the "Agreement") to sell assets related to our CMF implant and accessory product line to Medtronic for what resulted in total net consideration of $15,500,000. In accordance with the terms of the Agreement, we received an initial payment of $13,000,000 from Medtronic and a first milestone payment of $1,000,000 in the fourth quarter of 2002. A final milestone payment of $1,500,000 was received in 2004.

The Agreement requires us not to market in the craniomaxillofacial field, for five years, any products that compete with the acquired product line. Additionally, during the technology transfer transition period, we agreed to be a back-up supplier of CMF products to Medtronic at a price equal to our cost of manufacture.

The Agreement also allowed us to receive up to $5,000,000 if and when we completed successful clinical evaluations for a new faster-resorbing polymer product, as defined in the Agreement. In January 2004, after we completed the successful clinical evaluations, we received a $5,000,000 milestone payment from Medtronic and it was recognized as gain on sale of assets, related party, in the statement of operations.

In a separate, but simultaneous, 2002 transaction, we paid Medtronic $4,000,000 in cash to amend an existing Development and Supply Agreement (the "Amended Development Agreement", and collectively with the Asset Purchase Agreement, the "Agreements") to remove a preexisting contractual right of first offer for distributorship by Medtronic of our bioresorbable thin film products for use in various types of soft tissue surgical applications. Medtronic will retain its right of first offer for distributorship of our other bioresorbable products in all fields, as well as to our bioresorbable thin film products for use in the spinal application field. In addition, the term of the Amended Development Agreement with Medtronic was extended to September 30, 2012.

We accounted for the net proceeds of the Agreements as deferred gain on sale of assets, related party. This gain was to be recognized only as certain events occurred. For instance, we recognized a portion of the deferred gain upon the sale of the CMF products to Medtronic under our back-up supply arrangement, which provided for sales of the CMF products to Medtronic at cost. The amount of the deferred gain recognized was equal to the excess of the fair value of products sold, based on historical selling prices of similar products, over our manufacturing cost. The remainder of the deferred gain was recognized in the third quarter of 2004 when the technology and know-how transfer was completed pursuant to the contract terms.

Results of Operations

Revenues

The following table summarizes the components of our revenues for the three and nine months ended September 30, 2005 and 2004:

	For the three months ended September 30,				For the nine months ended September 30,			
	2005	2004	$ Difference	% Difference	2005	2004	$ Difference	% Difference
Regenerative cell technology:								
Research grant (NIH)	$ 25,000	$ 129,000	$ (104,000)	(80.6)%	$ 110,000	$ 229,000	$ (119,000)	(52.0)%
Regenerative cell storage services	2,000	2,000	—	—	6,000	8,000	(2,000)	(25.0)%
Total regenerative cell technology	27,000	131,000	(104,000)	(79.4)%	116,000	237,000	(121,000)	(51.1)%
MacroPore Biosurgery:								
Spine and orthopedics products	1,544,000	298,000	1,246,000	418.1%	4,776,000	2,831,000	1,945,000	68.7%
Thin Film products:								
Product sales (non-MAST-related)	—	—	—	—	—	559,000	(559,000)	—
Product sales to MAST	—	641,000	(641,000)	—	—	864,000	(864,000)	—
Amortization of gain on sale (MAST)	—	546,000	(546,000)	—	—	735,000	(735,000)	—
	—	1,187,000	(1,187,000)	—	—	2,158,000	(2,158,000)	—
Craniomaxillofacial (CMF) products:								
Product sales	—	—	—	—	—	126,000	(126,000)	—
Amortization of gain on sale	—	—	—	—	—	156,000	(156,000)	—
	—	—	—	—	—	282,000	(282,000)	—
Development (Senko)	11,000	158,000	(147,000)	(93.0)%	20,000	158,000	(138,000)	(87.3)%
Total MacroPore Biosurgery	1,555,000	1,643,000	(88,000)	(5.4)%	4,796,000	5,429,000	(633,000)	(11.7)%
Total revenues	$ 1,582,000	$ 1,774,000	$ (192,000)	(10.8)%	$ 4,912,000	$ 5,666,000	$ (754,000)	(13.3)%
% attributable to Medtronic	97.6%	16.8%			97.2%	50.0%		

Regenerative cell technology:

- 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, 2005, we incurred $25,000 and $108,000, respectively, in qualifying expenditures. We recorded a total of $25,000 and $110,000 in revenues, for the three and nine months ended September 30, 2005, respectively, which includes allowable grant fees as well as cost reimbursements. We incurred $93,000 and $246,000 in qualifying expenditures during the three and nine months ended September 30, 2004, and recorded revenues of $129,000 and $229,000 for the same periods.

  Although our primary focus is on discovery and development of new therapies for diseases and conditions using regenerative cell technologies, many of our development activities are still in a preclinical (or earlier) stage, and we do not expect to realize recurring revenue streams from these efforts until sometime in the future. Consequently, substantially all of our revenue is currently generated by sales of bioresorbable products, as discussed below. See also "The future" discussion below.

MacroPore Biosurgery:

- Spine and orthopedic revenues represent sales of bioresorbable implants used in spine and orthopedic surgical procedures. These revenues were dominated by stocking orders during the nine months ended September 30, 2005 for our radiographically identifiable Spine System products, marketed under the name MYSTIQUE™, which our distribution partner, Medtronic, launched in the third quarter of 2005. This product represents the latest design addition to our family of HYDROSORB™ products. Its unique feature is the integration of small markers of radiographically visible resorbable material within the product. These patent pending markers enable surgeons to preserve the benefit of fusion visualization, while simultaneously tracking the exact position of the implant during the intra-operative and post-operative periods. Because the markers are fabricated from a resorbable material, they do not pose the issues that permanent markers could pose after the implant resorbs.

  Due to Medtronic's dwindling orders for non-MYSTIQUE™ products in the HYDROSORB™ family, we recorded an inventory provision of $46,000 and $132,000 in the second and third quarters of 2005, respectively.

  Refer to "The future" discussion below for our expectations regarding the outlook for spine and orthopedic revenues. Note that Medtronic owns approximately 6.6% of our outstanding common stock at September 30, 2005.

- Thin Film product revenues in 2004 represent sales of SurgiWrap™ bioresorbable Thin Film used to support and reinforce soft tissues and to minimize tissue attachment to the device in case of contact with the viscera (organs of the body). We sold most, but not all, of our intellectual property rights and tangible assets related to our Thin Film product line to MAST in the second quarter of 2004. We were obliged by contract to act as a back-up supplier for these products and to sell them to MAST at our manufacturing costs. However, as MAST has now assumed the manufacturing process, domestic revenue from Thin Film products ended in 2004. No revenues from the Thin Film product line were recognized during the nine months ended September 30, 2005.

- The CMF product revenues represent sales of the CMF product line used for trauma and reconstructive procedures in the mid-face and craniofacial skeleton (the head and skull). We sold this product line to Medtronic in 2002. As with the Thin Film products, we sold CMF products at cost in 2004 under a contractual back-up supply agreement with Medtronic. A portion of the deferred gain related to sale of assets was recognized in order to reflect the fair value of products sold, based on historical selling prices of similar products, over our manufacturing cost. During the third quarter of 2004, we completed all remaining performance obligations related to the 2002 sale of the CMF product line to Medtronic. Therefore, we did not earn any CMF product revenues during the nine months ended September 30, 2005 and will not generate revenue from this product line in the future.

- 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 development revenue. Of the amount deferred, we have recognized development revenues of $11,000 and $20,000 in the three and nine months ended September 30, 2005, representing the relative fair value of the completed milestones completed during the periods presented as compared with the fair value of all milestones expected to be necessary to achieve regulatory approval by the MHLW;

  - Upon the achievement of commercialization of the Thin Film product line in Japan, we are entitled to a nonrefundable payment of $250,000. As of September 30, 2005, commercialization had not occurred; however, commercialization is expected to occur in the fourth quarter of 2005 or early 2006.

The future. 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. To date, we have received and recognized $338,000 of such funding. We expect to incur additional "qualifying

expenses" of $512,000 during the remainder of 2005 and in 2006. Subject to satisfactory progress toward meeting the goals and objectives of our grant application, we expect to recognize any remaining grant revenues during 2005 and 2006.

We sell our spine and orthopedic products exclusively to Medtronic at fixed selling prices that are subject to adjustment biannually (based on Medtronic's selling prices to its customers). Our revenue from this product line is dependent upon the market's adoption of our technology, which is largely dependent upon Medtronic's marketing efforts and pricing strategies. To increase our revenues from spine and orthopedic products, we depend largely on Medtronic's ability and commitment to build and expand HYDROSORB™ market share. We currently anticipate additional orders for the MYSTIQUE™ portion of the HYDROSORB™ product line during the remainder of 2005. We have, however, been disappointed in the past by Medtronic's level of effort in marketing our HYDROSORB™ products with the exception of the MYSTIQUE™ line. It is unlikely that we will see large sales of the current non-MYSTIQUE™ products in the future.

We will continue to recognize revenue from the milestone payment from Senko, based on the fair value of the milestones completed relative 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 2005 or early 2006. Accordingly, we expect to recognize approximately $1,322,000 in revenues associated with this milestone arrangement during the fourth quarter of 2005 and/or in the early part of 2006.

We expect the currently high percentage of revenues attributable to Medtronic to remain high now that domestic Thin Film revenues have ceased, although this may change when commercialization of the Thin Film products in Japan occurs and we begin Thin Film shipments to Senko.

Cost of revenues

Cost of revenues includes material, manufacturing labor, overhead costs and inventory provisions. The following table summarizes the components of our cost of revenues for the three and nine months ended September 30, 2005 and 2004:

	For the three months ended September 30,				For the nine months ended September 30,			
	2005	2004	$ and % Difference	% Difference	2005	2004	$ and % Difference	% Difference
MacroPore Biosurgery:								
Cost of revenues	$ 796,000	$ 1,184,000	$ (388,000)	(32.8)%	$ 2,233,000	$ 2,375,000	$ (142,000)	(6.0%)
% of revenues	50.3%	66.7%	(16.4)%	(24.6)%	45.5%	41.9%	3.6%	8.6%
Inventory provision	132,000	—	132,000	—	178,000	242,000	(64,000)	(26.4)%
% of revenues	8.3%	—	8.3%	—	3.6%	4.3%	(0.7)%	(16.3)%
Total cost of revenues	$ 928,000	$ 1,184,000	$ (256,000)	(21.6%)	$ 2,411,000	$ 2,617,000	$ (206,000)	(7.9)%
Total cost of revenues as% of revenues	58.6%	66.7%			49.1%	46.2%		

MacroPore Biosurgery:

- As our product revenues are currently generated through sales of bioresorbable products, cost of revenues is related only to our bioresorbable segment. Cost of revenues, as a percent of revenues (excluding inventory provision amounts), decreased 24.6% and increased 8.6% in the three and nine months ended September 30, 2005, respectively, as compared to the same periods in 2004. The percentage increase for the nine months ended September 30, 2005, as compared to 2004, was due to changes in the product mix and changes in absorption rates for manufacturing labor and overhead costs.

- Excess manufacturing costs – that is, costs resulting from lower than "normal" production levels - expensed in the three and nine months ended September 30, 2005 were $341,000 and $532,000, respectively, as compared to $468,000 and $666,000 in the same periods in 2004.

- In the third quarter of 2005, we recorded a provision of $132,000, primarily for excess HYDROSORB™ inventory not relating to the MYSTIQUE™ product line. The inventory was produced in anticipation of stocking orders from Medtronic which have not materialized. We have determined it is more likely than not that the inventory will not be recovered. The provision has been charged to cost of sales in the third quarter and will be maintained in a reserve account. A similar provision for $46,000 was recorded in the second quarter of 2005, for a total inventory reserve balance of $178,000 as of September 30, 2005.

  The $242,000 inventory provision during 2004 related to excess inventory produced in consideration of our responsibility to be a back-up supplier for the CMF product line. We sold the assets related to this product line to a subsidiary of Medtronic in September 2002. In April of 2004, Medtronic indicated that it would no longer purchase CMF inventory from us under the back-up supply arrangement, leading to our determination that the remaining CMF inventory on hand would not be recoverable.

The future. Ceasing to manufacture the CMF product line and the non-Japan bioresorbable Thin Film product line, combined with the deterioration of Medtronic orders for HYDROSORB™ products other than MYSTIQUE™, deprives us of economies of scale and will negatively impact our margins until other sources of revenue grow large enough to compensate for the lost revenue.

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 and preclinical studies. It excludes related stock based compensation expenses. The following table summarizes the components of our research and development expenses for the three and nine months ended September 30, 2005 and 2004:

	For the three months ended September 30,				For the nine months ended September 30,			
	2005	2004	$ Difference	% Difference	2005	2004	$ Difference	% Difference
Regenerative cell technology:								
Regenerative cell technology	$ 4,005,000	$ 2,120,000	$ 1,885,000	88.9%	$ 9,307,000	$ 5,379,000	$ 3,928,000	73.0%
Research grants (NIH)	25,000	93,000	(68,000)	(73.1)%	108,000	246,000	(138,000)	(56.1)%
Total regenerative cell technology	4,030,000	2,213,000	1,817,000	82.1%	9,415,000	5,625,000	3,790,000	67.4%
MacroPore Biosurgery:								
Bioresorbable polymer implants	626,000	612,000	14,000	2.3%	2,043,000	2,375,000	(332,000)	(14.0)%

Development milestone-Senko	24,000	134,000	(110,000)	(82.1)%	91,000	134,000	(43,000)	(32.1)%
Total MacroPore Biosurgery	650,000	746,000	(96,000)	(12.9)%	2,134,000	2,509,000	(375,000)	(14.9)%
Total research and development expenses	$ 4,680,000	$ 2,959,000	$ 1,721,000	58.2%	$ 11,549,000	$ 8,134,000	$ 3,415,000	42.0%

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. The increases in regenerative cell technology expenses from 2004 to 2005 resulted primarily from the hiring of additional researchers, engineers and support staff. We incurred an additional $636,000 and $1,491,000 in labor-related expenses, including benefits, in the three and nine months ended September 30, 2005, respectively, as compared with 2004. Legal expenses increased by $546,000 and $549,000 for the three and nine months ended September 30, 2005, primarily due to legal expenses incurred in connection with the University of Pittsburgh's recently filed lawsuit challenging inventorship of our licensor's U.S. patent relating to adult stem cells isolated from adipose tissue. The majority of the remainder of the increases as compared with 2004 related to increases in professional services, preclinical studies expense, other supplies expense and increased rent expense of $703,000 and $1,888,000 in the three and nine months ended September 30, 2005, respectively.

- 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. In the three and nine months ended September 30, 2005, we incurred $25,000 and $108,000, respectively, of direct qualifying expenses relating entirely to Phase II. In the three and nine months ended September 30, 2004, we incurred $93,000 and $246,000, respectively, of direct qualifying expenses relating to both Phases I and II of the agreement. The decrease in expense from 2005 to 2004 was due to the fact that 2005 expenses related to only Phase II while 2004 expenses related to both Phases I and II.

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 in 2005 as compared with 2004 was a result of a strategic decision to strongly focus our research and development efforts on our regenerative cell technology.

- 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, 2005, we incurred $24,000 and $91,000, respectively, of expenses related to this regulatory and registration process. We had incurred $134,000 of expense in this regulatory and registration process for both the three and nine months ended September 30, 2004.

The future. We are developing a system to isolate autologous, homologous-use, regenerative cells. Simultaneously, we are generating scientific knowledge through internal research to support the clinical use of these cells and have made significant progress in understanding the potential clinical applications. Our most advanced stem and regenerative cell therapy currently in preclinical testing is for the repair of cardiovascular muscle tissue that is damaged after a heart attack. Our strategy is to continue to increase our research and development efforts in this field and we anticipate expenditures in this area of research to be approximately $12,000,000 to $14,000,000 for the year 2005. We are also researching therapies for spine and orthopedic conditions, gastrointestinal disorders and new approaches for aesthetic and reconstructive surgery. The expenditures will primarily relate to developing therapeutic applications and conducting preclinical studies on harvesting therapeutically useful quantities of regenerative cells.

We were successful with Phase I of the NIH research on Adipose-Derived Cell Therapy for Myocardial Infarction. Therefore, we were awarded Phase II of the NIH research grant. We expect additional research expenses to be incurred related to Phase II of this project during the remainder of 2005 and 2006.

We expect that our current research and development expenditures in the bioresorbable platform technology will remain reasonably stable for the balance of 2005. However, we will continue to invest in product development for biomaterial/polymer products to develop our pipeline of new and next generation spine and orthopedic products.

Also, although we are not litigants and are not responsible for any settlement costs, we expect to incur additional legal expenses in connection with the University of Pittsburgh's 2004 lawsuit.

Sales and marketing expenses

Sales and marketing expenses include costs of marketing personnel, tradeshows, and promotional activities and materials. They exclude related stock based compensation expenses. Medtronic is responsible for the distribution, marketing and sales support of our spine and orthopedic devices. Our bioresorbable Thin Film product line (before the sale of the non-Japan Thin Film business to MAST in May 2004) was distributed domestically through a dedicated sales force, independent sales representatives and internationally through independent distributors. The following table summarizes the components of our sales and marketing expenses for the three and nine months ended September 30, 2005 and 2004:

	For the three months ended September 30,				For the nine months ended September 30,			
	2005	2004	$ Difference	% Difference	2005	2004	$ Difference	% Difference
Regenerative cell technology:								
International sales and marketing	224,000	—	224,000	—	224,000	—	224,000	—
Total regenerative cell technology	224,000	—	224,000	—	224,000	—	224,000	—
MacroPore Biosurgery:								
General corporate marketing	106,000	248,000	(142,000)	(57.3)%	357,000	629,000	(272,000)	(43.2)%
Domestic sales and marketing	—	—	—	—	—	846,000	(846,000)	—
International sales and marketing	36,000	206,000	(170,000)	(82.5)%	513,000	591,000	(78,000)	(13.2)%
Total MacroPore Biosurgery	142,000	454,000	(312,000)	(68.7)%	870,000	2,066,000	(1,196,000)	(57.9)%
Total sales and marketing			)	(19.4)%			)	(47.0)%

expenses	$ 366,000	$ 454,000	$ (88,000	$ 1,094,000	$ 2,066,000	$ (972,000

Regenerative Cell Technology:

- International sales and marketing expenditures for the three and nine months ended September 2005, 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.

MacroPore Biosurgery:

- General corporate marketing expenditures relate to expenditures for maintaining our corporate image and reputation within the research and surgical communities. The decrease in 2005 as compared to 2004 was due to one-time costs incurred for an educational program we created in 2004 to inform end-users and distributors of the benefits and surgical applications for our biomaterials products. Additionally, in 2005 we allocated fewer personnel resources to general corporate marketing.

- Domestic sales and marketing expenditures relate to expenses associated with managing our domestic bioresorbable Thin Film product distribution, which included independent sales representatives and our domestic Thin Film sales consultants and marketing staff. The elimination of such expenses in 2005 as compared to 2004 was due to the transfer of our sales force and marketing staff to MAST upon the sale of the Thin Film product line to MAST in May 2004.

- 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 2005 as compared to 2004 relates to a decrease in personnel resources currently dedicated to this marketing group.

*The future***.** We project that general corporate marketing as well as our international sales and marketing expenditures will remain reasonably stable for the balance of 2005. We also expect sales and marketing expenditures related to the regenerative cell technology to increase as we continue to expand this business segment in support of 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. These costs are not broken out for segment management or reporting purposes. They exclude related stock based compensation expenses. The following table summarizes the general and administrative expenses for the three and nine months ended September 30, 2005 and 2004:

	For the three months ended September 30,				For the nine months ended September 30,			
	2005	2004	$ Difference	% Difference	2005	2004	$ Difference	% Difference
General and administrative expenses	$ 2,212,000	$ 1,502,000	$ 710,000	47.3%	$ 6,219,000	$ 4,303,000	$ 1,916,000	44.5%

- Salary and benefit expense increased by $232,000 and $579,000 in the three and nine months ended September 30, 2005, with respect to the same periods in 2004. This increase was caused by the additional hiring of general and administrative employees. Additional professional services costs of $307,000 and $753,000, which were largely comprised of increased legal expenses, as well as larger travel expenditures of $76,000 and $245,000, respectively, for the three and nine months ended September 30, 2005, also contributed to the increase in general and administrative expense. The remaining increases of $95,000 and $339,000 for the same periods resulted from increased rent expense and various other miscellaneous expenses.

The future. We expect general and administrative expenses to continue to increase as we incur costs for professional services related to Sarbanes-Oxley compliance and expand our business activities.

Stock based compensation expenses

Stock based compensation expenses include charges related to options issued to employees, directors and non-employees. The stock based compensation expenditures connected to options granted to employees and directors (in their capacity as board members) is the difference between the exercise price of the stock based awards and the deemed market value of the underlying common stock on the date of the grant. Unearned employee stock based compensation is amortized over the remaining vesting periods of the options, which generally vest over a four-year period from the date of grant. The stock based compensation expenditures connected to options granted to non-employees initially is the fair value of the underlying common stock on the initial date of grant, but such amount is updated over the vesting period until the non-employee has met the performance commitment. Stock based compensation expense related to common stock granted to non-employees is the fair value of the stock on the date of grant, even if such stock

contains sales restrictions. The following table summarizes the components of our stock based compensation expenses (excluding cost of revenues stock based compensation), for the three and nine months ended September 30, 2005 and 2004:

	For the three months ended September 30,				For the nine months ended September 30,			
	2005	2004	$ Difference	% Difference	2005	2004	$ Difference	% Difference
Regenerative cell technology:								
Research and development related	$ 4,000	$ —	$ 4,000	—	$ 67,000	$ —	$ 67,000	—
MacroPore Biosurgery:								
Research and development	112,000	—	112,000	—	112,000	32,000	80,000	250.0%

related								
Sales and marketing related	113,000	—	113,000	—	113,000	22,000	91,000	413.6%
Total MacroPore Biosurgery	225,000	—	225,000	—	225,000	54,000	171,000	316.7%
General and administrative related	112,000	—	112,000	—	112,000	71,000	41,000	57.7%
Total stock based compensation expenses	$ 341,000	$ —	$ 341,000	—	$ 404,000	$ 125,000	$ 279,000	223.2%

Regenerative cell technology:

- 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 $63,000 recorded in the second quarter of 2005 constitutes the entire expense related to this grant, 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.

MacroPore Biosurgery:

- In August 2005, our Chief Operating Officer ("COO"), ceased employment with us. We agreed to pay the former COO a lump sum cash severance payment of $155,164 and extended the exercise period for two years on 253,743 vested stock options. The intrinsic difference in value of the options due to the modification was $337,000. We have recorded an expense in the third quarter of 2005 to reflect the lump sum cash severance payment and the value of the vested stock options. The stock based compensation expense of $337,000 recorded in the third quarter of 2005 constitutes the entire expense related to these options, and no future period charges will be required. This $337,000 was allocated in the table above in equal portions among three departmental categories, consistent with previous allocations of the former COO's compensation expense.

- All unearned stock based compensation was fully expensed by the end of 2004 (prior to 2004, all such stock based compensation was granted to personnel associated with our bioresorbable implants segment).

The future. We may from time to time grant stock-based awards to consultants, in lieu of, or in addition to, cash compensation.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-based Payment" ("FAS 123R"). As amended by Securities and Exchange Commission Release No. 33-8586,"Amendment to Rule 4-01(a) of Regulation S-X Regarding the Compliance Date for Statement of Financial Accounting Standards No. 123 (Revised 2004), Share-Based Payment," FAS 123R is effective for annual periods beginning after June 15, 2005 (January 1, 2006 for us). Upon adoption, FAS 123R will require us to measure all share-based payment transactions, including those with employees, at fair value. Moreover, the fair value of share-based payment awards will be recognized as expense in the statements of operations over the requisite service period of each award. Employee stock options granted prior to the effective date of FAS 123R will, to the extent they vest after December 31, 2005, result in stock-based compensation expense charges beginning in 2006. FAS 123R also changes the manner in which deferred taxes are recognized on share-based payment awards, as well as the accounting for award modifications. Subsequent to the adoption of FAS 123R we plan to continue to grant options (which will result in an expense) to our employees and as appropriate, to non-employee service providers.

Change in fair value of option liability

The following is a table summarizing the change in fair value of option liability for the three and nine months ended September 30, 2005 and 2004:

	For the three months ended September 30,				For the nine months ended September 30,			
	2005	2004	$ Difference	% Difference	2005	2004	$ Difference	% Difference
Change in fair value of option liability	$ 924,000	$ —	$ 924,000	—	$ 984,000	$ —	$ 984,000	—

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, the fair value of this option has been re-measured at the end of the third quarter, under 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 liability. At September 30, 2005, the contractual term, interest rate and volatility assumptions under the Black-Scholes option pricing model were 1.25 years, 4.10% and 64.21%, respectively.

The future. Until exercise or expiration (on December 31, 2006), the fair value of the 2,200,000 share option will continue to be re-measured at the end of each reporting period, with movements in fair value reported in the statements of operations as changes in

the fair value of option liability. Note that if the market price of our common stock increases, the option will become more valuable, resulting in an additional charge in our statements of operations.

Restructuring charge

The following table summarizes the restructuring charges for the three and nine months ended September 30, 2005 and 2004:

	For the three months ended September 30,				For the nine months ended September 30,			
	2005	2004	$ Difference	% Difference	2005	2004	$ Difference	% Difference
Restructuring charge	$ —	$ 37,000	$ (37,000)	—	$ —	$ 107,000	$ (107,000)	—

- In September 2003, we closed an administrative office in Königstein, Germany in an effort to reduce costs and consolidate operations in the United States. The office was rented under an operating lease. A restructuring charge of $70,000 was recorded in the first half of 2004 related to our

remaining lease obligation for the property. During the third quarter of 2004, we negotiated a settlement of the remaining lease payment with the lessor. As a result of the settlement, we recorded an additional provision of $37,000 in the third quarter of 2004.

The future. The restructuring charge relating to the Germany office was finalized in 2004.

Other income

The following is a table summarizing the gain on sale of assets and gain on sale of assets, related party for the three and nine months ended September 30, 2005 and 2004:

	For the three months ended September 30,				For the nine months ended September 30,			
	2005	2004	$ Difference	% Difference	2005	2004	$ Difference	% Difference
Gain on sale of assets	$ 5,526,000	—	$ 5,526,000	—	$ 5,526,000	—	$ 5,526,000	—
Gain on sale of assets, related party	—	8,883,000	(8,883,000)	—	—	13,883,000	(13,883,000)	—
Total	$ 5,526,000	$ 8,883,000	$ (3,357,000)	(37.8)%	$ 5,526,000	$ 13,883,000	$ (8,357,000)	(60.2)%

- 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 recognizing the gain on sale of assets when 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 gain on sale of assets, related party related to milestone payments from Medtronic for the disposition of our CMF product line. Specifically, as part of the disposal arrangement, we agreed to complete clinical research regarding Faster Resorbable Polymer, an area that directly relates to the CMF product line we transferred to Medtronic. In January 2004 we received the $5,000,000 payment after fulfilling the research requirements set out in the CMF sale agreement. We also were obliged to transfer certain “know-how”, including manufacturing processes, patents, and other intellectual property, to Medtronic. This obligation was fulfilled and in the third quarter of 2004 we received $1,500,000 from Medtronic. These milestones represented the last of all remaining performance obligations related to the 2002 sale of the CMF product line and accordingly, we recorded as gain on the sale of assets, related party, $7,383,000 representing the remaining balance as deferred gain on sale of assets, related party.

Financing items

The following table summarizes interest income, interest expense, and other income (expense) for the three and nine months ended September 30, 2005 and 2004:

	For the three months ended September 30,				For the nine months ended September 30,			
	2005	2004	$ Difference	% Difference	2005	2004	$ Difference	% Difference
Interest income	$ 99,000	$ 68,000	$ 31,000	45.6%	$ 208,000	$ 180,000	$ 28,000	15.6%
Interest expense	(31,000)	(44,000)	13,000	(29.5)%	(107,000)	(131,000)	24,000	(18.3)%
Other income (expense)	(13,000)	1,000	(14,000)	(1400.0)%	(52,000)	(20,000)	(32,000)	(160.0)%
Total	$ 55,000	$ 25,000	$ 30,000	120.0%	$ 49,000	$ 29,000	$ 20,000	69.0%

- Interest income increased from 2004 to 2005 due to higher returns on investments, while interest expense decreased due to declining principal balances on our long-term borrowings.

- The changes in other income (expense) in 2005 as compared to 2004 resulted primarily from changes in foreign currency exchange rates.

Deferred other

In the second quarter of 2005, we entered into a definitive Common Stock Purchase Agreement with Olympus in which we received $11,000,000 in cash proceeds. Under the Common Stock Purchase Agreement, we distributed 1,100,000 newly issued shares of common stock to Olympus, as well as an option to purchase 2,200,000 additional shares of common stock at a fixed price of $10.00 per share.

The $11,000,000 in total proceeds we received exceeded the sum of the fair value of the option granted as well as the market price of our stock at the time the Olympus share purchase was agreed upon. The difference between the proceeds received and the sum of the fair values of our common stock and initial option liability has been recorded as deferred other. Deferred other will be re-characterized in the future as events and circumstances dictate.

Deferred license fee revenue

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.

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

We will begin to recognize this $1,500,000 deferred license fee as revenues only after commercialization has been achieved. We will recognize the revenues on a systematic basis over the expected period of time we anticipate that Senko will benefit from the arrangement. However, we will not recognize

deferred license fee revenue if this would cause the remaining deferred license fee revenue balance to fall below the amount that we potentially would have to refund to Senko.

We expect commercialization to be achieved in the fourth quarter of 2005 or early 2006.

Deferred development revenue

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

- Upon our notification to 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.
- Upon the achievement of commercialization, we are entitled to a nonrefundable payment of $250,000.

We notified Senko on September 28, 2004 regarding the completion of the initial regulatory application, received $1,250,000 in cash and recorded deferred development revenue of $1,250,000. Of the amount deferred, we have recognized development revenues totaling $178,000 ($20,000 in 2005 and $158,000 in 2004). These revenues represent the fair value of the completed milestone relative to the fair value of the total efforts expected to be necessary to achieve regulatory approval by the MHLW.

Option liability

We granted Olympus Corporation an option to acquire 2,200,000 shares of Cytori stock on or before December 31, 2006. The exercise price of each option is $10 per share. We accounted for this grant as a liability in accordance with EITF 00-19. The 2,200,000 share option has been classified as a liability because we are required to deliver listed shares of our common stock to settle the option shares upon exercise. Accordingly, the fair value of the 2,200,000 share option has been (and will continue to be) re-measured at the end of each reporting period, with movements in fair value reported in the statements of operations as changes in the fair value of option liability.

Liquidity and Capital Resources

The following is a summary of our key liquidity measures at September 30, 2005 and December 31, 2004:

	September 30, 2005	December 31, 2004	$ Difference	% Difference
Cash and cash equivalents	$ 2,275,000	$ 2,840,000	$ (565,000)	(19.9)%
Short-term investments, available for sale	7,284,000	10,579,000	(3,295,000)	(31.1)%
Total cash and cash equivalents and short-term investments, available for sale	$ 9,559,000	$ 13,419,000	$ (3,860,000)	(28.8)%
Current assets	$ 11,488,000	$ 15,645,000	$ (4,157,000)	(26.6)%
Current liabilities	4,664,000	3,267,000	1,397,000	42.8%
Working capital	$ 6,824,000	$ 12,378,000	$ (5,554,000)	(44.9)%

We believe that existing funds, cash generated by operations, and existing and accessible sources of financing are adequate to satisfy our working capital, capital expenditures, debt service and other financial commitments at least through September 30, 2006. However, 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 (see discussion below regarding the Olympus collaboration agreements, which were entered into in November 2005).

From inception to September 30, 2005, 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, and
- Closing a Stock Purchase Agreement with Olympus in May 2005.

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 1.1 million shares of our common stock to Olympus at $10.00 per share. 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 collaboration agreements, we will form a joint venture with Olympus, Olympus-Cytori, Inc., to develop and manufacture future generation devices based on our Celution™ System. Pursuant to the terms of the agreements, we will receive upon closing $11 million in cash in the fourth quarter of 2005; this cash is incremental to the proceeds received under the Olympus equity investment described above. We also will be entitled to receive an additional $11 million upon our receipt of a CE mark for the first generation Celution™ System, which is expected to occur in the first half of 2006. We may possibly receive even more proceeds if Olympus decides to exercise its option to purchase 2,200,000 shares of our common stock at a fixed price of $10.00 per share.

We believe that our near-term borrowing requirements and debt repayments will continue to involve a relatively small amount of cash. To fund 2005 expected capital expenditures of $1,500,000, we intend to use available working capital and if available, borrow under our Amended Master Security

Agreement.

Any excess funds will be invested in short-term available-for-sale investments. We believe that it is necessary to maintain a large amount of cash and short-term available-for-sale investments on hand to ensure that we have adequate resources to fund future research and development, and to manage legal and regulatory risks and challenges to our business model.

Our capital requirements for the remainder of 2005 and beyond will depend on numerous factors, including the resources we devote to developing and supporting our products, Medtronic's marketing efforts, market acceptance of our developed products, regulatory approvals and other factors. We have positioned ourselves to expand our cash position through actively pursuing co-development and marketing agreements, research grants, and licensing agreements related to our technology platforms. Moreover, we are committed to increasing revenues from our bioresorbable products. The revenue generated from our bioresorbable products will depend in large part on the success of Medtronic's (our sole distributor of spine and orthopedics implants) marketing efforts in the bioresorbable spine and orthopedics arena.

We expect to incur research and development expenses, well beyond our current level, in our regenerative cell platform for an extended period of time. This will occur whether or not our spine and orthopedics biomaterials business reaches profitability. We will continue to seek collaborations and new sources of financing, beyond those entered into with Olympus, in order to fund operations, satisfy financial obligations, and achieve our research and development objectives.

The following summarizes our contractual obligations and other commitments at September 30, 2005, 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 debt obligations	$ 1,347,000	$ 689,000	$ 658,000	$ —	$ —
Interest commitment on debt	128,000	87,000	41,000	—	—
Operating lease obligations	7,988,000	1,943,000	4,985,000	1,060,000	—
Leasehold improvement obligations	757,000	757,000	—	—	—
Research study obligations	408,000	408,000	—	—	—
Total	$ 10,628,000	$ 3,884,000	$ 5,684,000	$ 1,060,000	$ —

Cash provided by (used in) operating, investing and financing activities for the nine months ended September 30, 2005 and 2004, is summarized as follows:

	For the nine months ended September 30,	
	2005	**2004**
Net cash used in operating activities	$ (13,305,000)	$ (9,388,000)
Net cash provided by investing activities	2,252,000	10,149,000
Net cash provided by (used in) financing activities	10,488,000	(595,000)

Operating activities

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

Net cash used in operating activities in the nine months ended September 30, 2004 primarily resulted from our net loss, adjusted for material non-cash activities, such as the gain on sale of assets, related party, and other material non-cash activities and changes in working capital due to the timing of product shipments and payment of liabilities.

Operating losses for both periods as well as the increase in cash used in operating activities during 2005 versus 2004 resulted largely from expenses related to our research and development efforts for regenerative cell therapies.

Investing activities

Net cash provided by investing activities in the nine months ended September 30, 2005 and 2004 resulted primarily from the sale and maturity of our short-term investments, the proceeds from which were used to fund operating activities during 2005.

Net cash provided by investing activities in the nine months ended September 30, 2004 resulted in part from the receipt of the non-recurring payment of $6,500,000 for the completion of the CMF Faster Resorbable Polymer clinical research and the transfer of the know-how related to the 2002 sale of the CMF Product Line to Medtronic. In addition, we received net proceeds of $6,934,000 from the sale of our Thin Film product line (except for the territory of Japan) to MAST.

Capital spending is essential to our product innovation initiatives and to maintain our operational capabilities. In the nine months ended September 30, 2005 and 2004, we used cash to purchase $1,052,000 and $673,000 respectively, of property and equipment to support manufacturing of our bioresorbable implants and for the research and development of the regenerative cell technology platform.

Financing Activities

The net cash provided by financing activities in the nine months ended September 30, 2005 related mainly to the $11,000,000 sale of common stock to Olympus. The composition of the $11,000,000 in proceeds includes: $3,003,000 for the sale of common stock, $186,000 for the issuance of options, and

$7,811,000 for the issuance of common stock in excess of fair market value, which may be

re-characterized in the future as events and circumstances dictate.

The net cash used in financing activities in the nine months ended September 30, 2004 related to:

- The repurchase of 290,252 shares of our common stock for $1,052,000; and
- The payment of $608,000 on our long term obligations.

Net cash used in financing activities in 2004 was offset by proceeds from an Amended Master Security Agreement we entered in September 2003 to provide financing for equipment purchases. In the first nine months of 2004, in connection with this agreement, we issued promissory notes with principal amounts totaling approximately $1,039,000.

Critical Accounting Policies and Significant Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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 are 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,
- Upfront payments from license or distribution agreements, and
- Fees for achieving certain defined milestones under development or commercialization 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 the NIH and Senko. Moreover, some of our non-recurring transactions, such as our disposition of the majority of our Thin Film business to MAST or our sale of our CMF product line to Medtronic, 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 milestone 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 nature 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).

Our conclusions, in effect, cause us to recognize certain revenues from the Senko Distribution Agreement sooner than if we had alternatively concluded that none of the elements in the arrangement were separable. Notably, we have recognized $178,000 in cumulative development revenues from the Senko Distribution Agreement, mostly related to achieving certain milestones related to the commercialization of Thin Film products in Japan. Had our judgments regarding the separation of elements been different, we likely would have recognized as revenues an amount less than this.

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
  - As part of the Senko Distribution Agreement, we received an upfront fee upon execution of the arrangement. We concluded that such fee was not earned at that time and, instead, reported the cash as deferred license fee revenue. We then had to consider over what period the upfront fee should be recognized as revenue, especially considering that the fee was refundable under certain conditions. We ultimately concluded that the fee would be earned – and, thus recognized as revenues – beginning when regulatory approval was received to market Thin Film products in Japan. We further concluded that revenues would be reported on a straight-line basis over a five year period. We selected the straight-line method because we otherwise could not reliably estimate the manner in which Senko would benefit from the terms of the Distribution Agreement. The license fees will be recognized over a five year period as this corresponds to the initial term of the Distribution Agreement. However, because a pro-rata share of the license fee must be returned to Senko if we terminate the Distribution Agreement at any time within the initial three years post-commercialization, in no event will we recognize these revenues if this would cause the remaining deferred balance to fall below the amount we would potentially have to refund to Senko. We note that the Distribution Agreement is renewable for an additional five year period upon mutual consent of Senko and MacroPore. However, we believe that it is too soon to judge whether Senko will benefit from the upfront license fee payment for longer than the initial five year term; we will re-examine this assumption each reporting period and make any necessary adjustments on a prospective basis.
- 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 income statement. 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 research 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.
- Milestones
  - In certain of our non-governmental development arrangements, we receive payments upon the achievement of certain defined milestones. Our accounting policy is to recognize milestone payments as revenues when received if:
    - Substantive effort is required to achieve the milestone,
    - The amount of the milestone payments appears reasonably commensurate with the effort expended, and

- Collection (or retention) of the payment is reasonably assured.

- Determining whether each of these criteria has been satisfied requires significant judgment. For example, our Distribution Agreement with Senko calls for payments to us when certain defined milestones are achieved. 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 compared with other steps we believe are necessary to commercialize the Thin Film product line in Japan. Accordingly, we did not recognize the $1,250,000 received as revenues, but instead have recorded all but $178,000 of this amount as deferred development revenue. The $178,000 ($20,000 in 2005 and $158,000 in 2004) was recognized as development revenues based on our estimates of the level of effort expended 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. Indeed, there can be no assurance that commercialization in Japan will ever be achieved, although our latest understanding is that regulatory approval may be received in the fourth quarter of 2005 or in early 2006.

- Back-up Supply Arrangements

  - We agreed to serve as a backup supplier of products in connection with our dispositions of both:

    - The CMF product line to Medtronic; and
    - Specific Thin Film assets to MAST.

    Specifically, we agreed to supply CMF or Thin Film product to Medtronic and MAST, respectively, at our cost for a defined period of time. When we actually delivered products under the backup supply arrangements, 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 backup 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 the Company's 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. We recognize that others may conclude that the receipt of amounts under the NIH royalty arrangement should be presented as a reduction of any qualifying expenses incurred – that is, reported in the income statement on a net basis.

Warranty Provisions

At the time of sale, we grant customers the right to a full refund if (and only if) the purchased medical device does not meet all of the agreed upon specifications and expectations. Accordingly, we established a liability for the estimated cost of honoring this warranty at the same time we record revenues from the sale of the related medical device.

We believe the accounting estimate related to our warranty liability is a "critical accounting estimate" because changes in the related warranty provision can materially affect our operating results. Moreover, because of our limited history and our continual development of new products, estimating our expected warranty costs requires significant judgment.

In the past, our warranty provision was based primarily on actual history of warranty claims submitted by our customers. Before the third quarter of 2003, we had de minimis warranty claims despite recognizing approximately $27 million in cumulative sales of medical devices. Accordingly, we had no warranty reserves prior to the third quarter of 2003.

In the third quarter of 2003, we determined that some of the products we sold did not meet certain customer expectations, based on criteria previously communicated to our customer (Medtronic). After detecting this matter, we elected to replace all lots of affected inventory that were on hand at the customer, and we subsequently modified our procedures to alleviate similar occurrences in the future.

As a result, we recorded a warranty charge of $243,000 in the third quarter of 2003. We have incorporated this new historical warranty data into our determination of appropriate warranty reserves to record prospectively and will continue to evaluate the adequacy and accuracy of our warranty obligations on a quarterly basis. There have been no material warranty claims since the third quarter of 2003.

Goodwill Impairment Testing

In late 2002, we acquired StemSource, Inc. by merger 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 30,2005. 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 reasonably 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 2004, 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.

This allocation process involves judgment. 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 bioresorbable 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 bioresorbable 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, we estimated the fair value of our bioresorbable 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 involves 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. Notably, the carrying value of our regenerative cell reporting unit, including assigned goodwill, totaled $7,100,000 as of the 2004 testing date. Furthermore, we estimated the fair value of this reporting unit to be $12,600,000 as of this date, meaning that a change in how certain assets and liabilities were allocated to our reporting units, or the manner in which we estimated fair value, could have resulted in a different conclusion as to whether some of our goodwill was impaired.

Dispositions

In 2002, we sold our CMF (skull and face) bone fixation implant and accessory product line to Medtronic.

Moreover, in 2004, we sold most of the assets and intellectual property rights in our (non-Japan) Thin Film business 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 Medtronic or MAST personnel on production and other aspects of the CMF and Thin Film product lines, respectively.
- Provide a back-up supply of CMF product to Medtronic and Thin Film products to MAST, at cost, for a specified period of time,
- In the case of Medtronic, perform clinical evaluations for a new faster-resorbing polymer product.

Disposing 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.”

For instance, upon the closing of the CMF sale agreement on September 30, 2002, we received net cash of $9,000,000, and transferred assets to Medtronic with a net carrying value of $476,000. The net difference of $8,524,000 was recorded as part of a Deferred gain on sale of assets, related party on our balance sheet. We deferred recognition of the majority of this gain until Medtronic accepted the transferred net assets, which was demonstrated only when Medtronic had:

- Stopped relying on us to provide product under the back-up supply agreement,
- Integrated the acquired CMF manufacturing equipment into its operations, and
- Permitted us to deliver training to Medtronic personnel on production and other aspects of the CMF product line.

Until those events occurred, we did not believe that we have transferred all risk and rewards related to the CMF product line to Medtronic and, accordingly, recognition of the deferred gain in earnings would be inappropriate.

The risks and rewards of ownership related to the CMF product line ultimately passed to Medtronic in August 2004. The remainder of the deferred gain was recognized in the third quarter of 2004 when the technology and know-how transfer was completed pursuant to the contract terms.

We also 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. It has been concluded, due to the arbitration proceedings settled in August 2005, that we have completed our remaining performance obligations during the third quarter of 2005. Accordingly, we have 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 Medtronic and MAST under the respective back-up

supply agreements. Refer to the "Revenue Recognition" section of this Critical Accounting Policies and Significant Estimates discussion for further details.

Recent Accounting Pronouncements

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs-An Amendment of ARB No. 43, Chapter 4" ("FAS 151"). FAS 151 clarifies that abnormal amounts of idle facility expense, freight, handling costs and spoilage should be expensed as incurred and not included in overhead. Further, FAS 151 requires that allocation of fixed and production facilities overhead to conversion costs should be based on normal capacity of the production facilities. The provisions in FAS 151 are effective for inventory costs incurred during fiscal years beginning after June 15, 2005. We do not believe that the adoption of FAS 151 will have a significant effect on our financial statements.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-based Payment" ("FAS 123R"). As affected by Securities and Exchange Commission Release No. 33-8568, "Amendment to Rule 4-01(a) of Regulation S-X Regarding the Compliance Date for Statement of Financial Accounting Standards No. 123 (Revised 2004), Share-Based Payment", FAS 123R is effective for us on January 1, 2006 and will have a material effect on our results of operations. Upon adoption, FAS 123R will require us to measure all share-based payment transactions, including those with employees, at fair value (most notably, this includes employee stock option grants, even where the exercise price is equal to the grant date fair market value). Moreover, the fair value of share-based payment awards will be recognized as expense in the statements of operations over the requisite service period of each award. FAS 123R also changes the manner in which deferred taxes are recognized on share-based payment awards, as well as the accounting for award modifications.

Based on pro forma amounts for historical periods presented in Note 4 of our consolidated financial statements, our net loss will increase (or our net income will be reduced) each period as a result of adopting FAS 123R.

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 cause or contribute to differences in our actual results include those discussed in the following subsection, 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. Each of the following risk factors, either alone or taken together, could adversely affect our business, operating results and financial condition, as well as adversely affect the value of an investment in our common stock.

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

<u>We have a limited operating history; our operating results can be volatile</u>

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 medical device and biotechnology field. Due to our limited operating history, 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. This was demonstrated by our revenue decline in the second, third, and fourth quarters of 2004 and the nine months ended September 30, 2005.

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, 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.

We had tried to influence our investors' expectations as to our 2004 operating results by periodically announcing financial guidance. However, due to our disappointing revenues in the second quarter of 2004 and our conclusion that we did not have sufficient visibility on the timing and size of end customer demand for the HYDROSORB™ bioresorbable implants which we distribute through Medtronic, we withdrew our previously issued guidance on July 19, 2004. We have advised the markets that revenues for these products, including the new MYSTIQUE™ line, in 2005 are expected to be in the range of $6,000,000 to $9,000,000. We now think the 2005 revenues will be toward the lower end of that range.

<u>We have never been profitable on an operational basis</u>

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. We anticipate that our recurring operating expenses will increase for the next several years, due to the continued need to develop new products and fund additional preclinical research and possibly clinical trials. We expect to continue to incur operational losses in our spine and orthopedics business at least through the end of 2005, and the amount of future net losses and time

necessary to reach operational profitability are somewhat uncertain. 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 are adopting a high-risk strategy

We intend to use cash from any profits of the HYDROSORB™ products and the Japan Thin Film products, the proceeds of the sale of the (non-Japan) Thin Film product line, and cash raised from future financings or any other source to finance the 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 successfully deliver regenerative cells where needed in the body (scientific risk), or that our cash resources will be adequate to develop the regenerative cell technology until it becomes profitable (if ever) while still serving the cash needs of our biomaterials medical device product lines (financial risk). Instead of using the cash to reinvest in our biomaterials business, we are using it in one of the riskiest industries in the economy (strategic risk). This has fundamentally changed our risk/reward profile from what it had been as recently as two years ago and may make our stock an unsuitable investment for some investors.

The financial risk in this strategy is significant, particularly if our bioresorbable products are not 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 the second quarter of 2004 due to the sharp reduction in orders from and sales to Medtronic. This was followed by an even sharper reduction in third and fourth quarter 2004 spine and orthopedics implant product orders from our sales to Medtronic, which has continued (except for stocking orders for the new MYSTIQUE™ line) in 2005. With the CMF and (non-Japan) Thin Film product lines sold and the Japanese Thin Film products not yet approved for commercialization, our only remaining bioresorbable implants business from which to derive product revenues in the short term is our spine and orthopedic implants product line.

Further legal risk arises from a lawsuit, filed by the University of Pittsburgh in the fourth quarter of 2004, seeking a determination that its assignors, rather than the University of California's assignors, are the true inventors of U.S. Patent No. 6,777,231. We are the exclusive, worldwide licensee from the University of California 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 materially adversely affected.

We must keep our joint venture with Olympus operating smoothly

Our regenerative cell business cannot succeed 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 will be stymied. 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, as we work together, major differences in interest and approach. Olympus is a large, long-established Japanese company whose primary profit opportunity here is in device manufacturing; we are an emerging American company whose primary profit opportunity here is in device marketing. In addition, our relationship is formally measured by a set of complex contracts, which have not yet been tested in practice. And, many aspects of the relationship will be essentially non-contractual, and must be worked our 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 in the face of various kinds of change, especially when the parties are separated by a great distance and (to some degree) language difficulties and cultural differences.

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 timely 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. is likely to need more money than its initial capitalization in order to finalize development of and finance the manufacturing of the future generation devices. If we are unable to provide future financing for Olympus-Cytori, Inc. relative equity interest in Olympus Cytori, Inc. may decrease.

Furthermore, under a License/Joint Development Agreement between Olympus-Cytori, Inc. and Olympus, 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 results in a reduction of our control over the development.

The joint venture will also result in a reduction or loss of our control over the manufacturing of the future generation devices, if and when they are developed.

Finally, one of our primary purposes in entering the joint venture was to obtain cash to finance our ongoing internal research and development. We agreed to defer receipt of $11 million of the earmarked cash until we receive the CE Mark for our first-generation Celution device. If for any reason we are unable to obtain the CE Mark, our receipt of that $11 million will be delayed indefinitely and our research and development financing plans will be disrupted.

We rely on Medtronic to distribute a majority of our current products

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. We have derived the majority of our revenues from the sale of hard-tissue-fixation bioresorbable implant products to our distribution partner, Medtronic.

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 its rate of product orders placed with us in the same period, disappointed our expectations with the exception of stocking orders for the new MYSTIQUE™ line. 2004 and 2005 results were exceptionally weak, and we are significantly disappointed with the marketing efforts of Medtronic for our non-MYSTIQUE™ products at this time. Indeed, we recorded an inventory provision for slow-moving non-MYSTIQUE™ inventory in the second and third quarters of 2005.

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 resulted in our second quarter 2004 falling short of our own and the market's expectations and compelled us to, on July 19, 2004, withdraw our previously announced financial guidance for the remainder of 2004.

The prices which Medtronic pays us are fixed (pending biannual price reviews), 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 6.6% 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.

There can be no assurance that our interests will continue to 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 the results of our operations and financial condition.

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 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 do not have the legal right to preclude other companies from making bioresorbable products that are similar to ours or perform similar functions.

These competitors may also have greater experience in developing bioresorbable products, conducting clinical trials, obtaining regulatory clearances or approvals, and manufacturing and marketing such 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 product commercialization earlier than we, any of which could have a substantial negative effect on our business. Finally, Medtronic and our other partners may 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 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 other very significant marketing expenditures or definitive product superiority. Such inertia may be one reason why demand for the HYDROSORB™ implants we sell through Medtronic was lower in 2004 and 2005 than we had expected.

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 may 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.

We depend on recently introduced products and anticipated new products, which subject us to development and marketing risks

We are in a relatively early stage of commercialization with many of our products although we have derived revenue from sales of certain products to our distributors, particularly Medtronic. We believe that our long-term viability and growth will depend in large part on receiving additional regulatory clearances or approvals for our products and expanding our sales and marketing for our spine and orthopedics implants and other new products that may result from our research and development activities. We are presently pursuing bioresorbable implant opportunities in spine and orthopedics and other tissue repair and regeneration throughout the body 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 product 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. Most of our cell-related products and/or services are at least three to five years away.

Moreover, the various applications and uses of our bioresorbable surgical implants are relatively new and evolving. The successful development and market acceptance of our products are subject to inherent developmental risks, including 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 distribution partners will be able to successfully commercialize or achieve market acceptance of 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 products or receive the required regulatory clearances or approvals could have a substantial negative effect on the results of our operations and financial condition.

We will need to raise more cash in the future

As of September 30, 2005, we had $9,559,000 of cash, cash equivalents and short-term investments; we have always had negative cash flow 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. 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 may 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 as well as our ability 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 limited manufacturing experience

We have a limited manufacturing history and limited experience in manufacturing some of our biomaterials products. In part, our future biomaterials success is significantly dependent on our ability to manufacture products 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 in some instances 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 would have a substantial negative effect on the results of our operations and financial condition.

We have no experience in manufacturing the Celution™ system or any other regenerative-cell products.

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 would be, subject to periodic inspection by regulatory authorities and distribution partners. The manufacture of those used 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, 2006, 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. 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 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 continue the development of the 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, recently filed by the University of Pittsburgh, seeking a determination that its assignors, rather than the University of California's assignors, are the true inventors of U.S. Patent No. 6,777,231. We are the exclusive, worldwide licensee from the University of California 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 materially adversely affected.

Our commercial success will also depend, in part, on our ability to avoid infringing patents issued to others. If we were judicially determined to be infringing 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 the University of Pittsburgh 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 may incur 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. Litigation could subject us to significant liabilities to third parties and require disputed rights to be licensed from third parties or require us to cease using certain technology.

In addition to patents, which as noted cannot protect the fundamentals of our bioresorbable technology and our bioresorbable business, we also rely on unpatented trade secrets and proprietary technological expertise. We rely, in part, on confidentiality agreements with our distribution 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 (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 subject to intensive FDA regulation

As newly developed medical devices, our bioresorbable surgical implants and our regenerative cell harvesting, isolation and delivery devices 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 current and future bioresorbable surgical implants for humans and our regenerative cell harvesting, isolation and delivery devices 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 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. The FDA approval process may be particularly problematic for our regenerative cell technology products in view of the novel nature of the technology. 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 will subject us to intensive regulation in foreign countries

In cooperation with our distribution partners, particularly Medtronic and Senko, 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. 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 its foreign regulatory approvals or clearances, or that we will be able to successfully commercialize its current or future products in any 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.

We may not have enough product liability insurance

The testing, manufacturing, marketing and sale of our surgical 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 current 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. It could discourage a third party from attempting to acquire control of us, 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 us 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 the change in control of the Company which could adversely affect the market price of our shares.

We cannot guarantee a liquid trading market for our stock

Our common stock is listed on the “Prime Standard” segment of the Frankfurt Stock Exchange. We cannot assure that this will result in a satisfactory trading market, particularly for United States investors. Also, there can be no assurance that we will achieve our goal to list our common stock on NASDAQ or a major United States stock exchange.

We pay no dividends

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

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

Our exposure to market risk due to fluctuations in interest rates relates primarily to short-term investments. These short-term investments, reported at an aggregate fair market value of $7,284,000 as of September 30, 2005, 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 inasmuch 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, 2005, 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. Although we transacted business in various foreign countries before the May 2004 sale of our non-Japan Thin Film business to MAST, settlements were usually based on the U.S. dollar. 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 third quarter ended September 30, 2005, 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 in the fourth quarter of 2005 or early 2006.

Foreign currency exchange rates can be obtained from the website at www.oanda.com.

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, 2005, 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 its business. As of September 30, 2005, we were not a party to any material legal proceeding.

On August 9, 2005, we reached settlement of the arbitration proceedings against MAST. The parties entered into a Settlement Agreement 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 two million dollars or to deliver 19% of its shares. Moreover, MAST agreed to supply all required product for any necessary clinical study for the territory of Japan – at no cost to us - and cooperate in the planning of such study. Neither party paid any cash to the other in the settlement.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

On September 27, 2005, we issued an aggregate of 22,223 shares of our common stock to Marshall G. Cox, our Chairman of the Board of Directors, upon exercise of three outstanding warrants, in exchange for Mr. Cox's payment to us of $50,001.75 in cash (or $2.25 per share, the warrant exercise price). The shares issued in this transaction were issued in reliance on the exemption from registration provided by Section 4(2) of the Securities Act, as such sales did not involve a public offering; no broker or underwriter commissions were paid.

Item 3. Defaults Upon Senior Securities

None

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

None

Item 5. Other Information

Material Agreements

On July 27, 2005, we entered into a Separation Agreement and General Release with John K. Fraser (attached hereto as Exhibit 10.25), who had been our Vice President of Research and Technology – Regenerative Cell Technology. In the agreement, the parties terminated their employment relationship and Dr. Fraser provided the Company with a general release of all claims. We agreed to pay COBRA premiums for Dr. Fraser and his family for continued coverage under the Company's group health plan for a period of six months. We also agreed to accelerate and vest 21,349 of Dr. Fraser's unvested stock options, and extend the exercise term for such accelerated options, as well as 80,855 of Dr. Fraser's previously vested shares (for a total of 102,204 stock options), through July 27, 2007.

On August 9, 2005, we entered into a Settlement Agreement with MAST Biosurgery AG and MAST Biosurgery, Inc. (attached hereto as Exhibit 10.26). The parties settled their pending 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 two million dollars or to deliver 19% of its shares. Moreover, MAST agreed to supply all required product for any necessary clinical study for the territory of Japan and cooperate in the planning of

such study. Neither party paid any cash to the other in the settlement.

Property

Our main facility for manufacturing is 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:

- 14,000 square feet, of which approximately 4,000 square feet is for research and development and 10,000 square feet is office space, at 6749 Top Gun Street, San Diego, California for a five-year term expiring in 2006. We currently sublease 6,000 square feet of this office and warehouse space at the rate charged per square foot in our current lease agreement. We sublease approximate 5,000 square feet to MAST and the remainder to another unrelated party.
- 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.

On the properties stated above, we pay an aggregate of approximately $60,000 in rent per month. The aggregate sublease amount is $6,000 per month.

On May 24, 2005, we entered into a new lease for 91,000 square feet located at 3020 and 3030 Callan Road, San Diego, California. We intend to continue to move the majority of our operations to this new facility over the next year. 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. In addition, we are committed to providing a minimum of $837,000 in improvements to the facility.

Staff

As of September 30, 2005, we had 127 full-time employees, comprised of 16 employees in manufacturing, 81 employees in research and development, 6 employees in sales and marketing and 24 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	—	16	—	16
Research & Development	74	7	—	81
Sales and Marketing	4	2	—	6
General & Administrative	—	—	24	24
Total	78	25	24	127

Item 6. Exhibits

3.1.1	Certificate of Ownership and Merger (effecting name change to Cytori Therapeutics, Inc.)
10.25	Separation Agreement and General Release dated July 15, 2005, between John K. Fraser and Cytori
10.26	Settlement Agreement dated August 9, 2005, between MAST Biosurgery AG, MAST Biosurgery, Inc. and Cytori
10.27	Severance Agreement and General Release dated August 10, 2005, between Sharon V. Schulzki and Cytori
10.28	Consulting Agreement dated July 15, 2005, between John K. Fraser and Cytori
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

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, 2005.

CYTORI THERAPEUTICS, INC.

Dated: November 14, 2005

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

Dated: November 14, 2005

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

CYTORI THERAPEUTICS, INC.

EXHIBIT INDEX

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CERTIFICATE OF OWNERSHIP AND MERGER
MERGING
CYTORI THERAPEUTICS, INC.
(a Delaware Corporation)
INTO
MACROPORE BIOSURGERY, INC.
(a Delaware Corporation)
(PURSUANT TO SECTION 253 OF THE DELAWARE GENERAL CORPORATION LAW)

MacroPore Biosurgery, Inc., a corporation organized and existing under the laws of the State of Delaware (the "Company"), does hereby certify:

1. The Company was incorporated on May 16, 1997 pursuant to the Delaware General Corporation Law.

2. The Company is the owner of all of the outstanding shares of each class of capital stock of Cytori Therapeutics, Inc., a Delaware corporation ("Subsidiary").

3. The Company, by the following recital and resolutions adopted on June 28, 2005 by the Board of Directors of the Company, determined to merge Subsidiary into the Company:

WHEREAS, the Board of Directors of the Company deems it to be advisable and in the best interests of the Company and its stockholders that the Company merge into itself its wholly-owned subsidiary, Cytori Therapeutics, Inc. ("Subsidiary"), and assume all of Subsidiary's liabilities and obligations;

NOW, THEREFORE, BE IT RESOLVED that Subsidiary shall be merged into the Company and the Company shall thereby assume all of Subsidiary's liabilities and obligations; and via such merger the corporate name of the Company shall, as authorized by Delaware General Corporation Law Section 253(b), be changed to Cytori Therapeutics, Inc. effective upon the effective date of such merger.

RESOLVED FURTHER, that, in accordance with the Delaware General Corporation Law, the Chief Executive Officer of the Company is hereby authorized to execute and acknowledge a Certificate of Ownership and Merger setting forth a copy of the resolutions to merge Subsidiary into the Company and to assume Subsidiary's liabilities and obligations (and to change the surviving corporation's name) and the date of adoption thereof and to file on July 11, 2005 such Certificate of Ownership and Merger with the Delaware Secretary of State and, if required, to record such certificate in the office of the recorder of each county in which the registered office of the Company or Subsidiary is located.

RESOLVED FURTHER, that the proper officers of the Company are hereby authorized to take such other actions and sign such other documents as may be necessary or appropriate to carry out the intent of the foregoing resolutions, and all prior actions taken in connection therewith are hereby confirmed, ratified and approved.

Executed on July 11, 2005

MACROPORE BIOSURGERY, INC.

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

Exhibit 10.25

SEPARATION AGREEMENT AND GENERAL RELEASE

This Separation Agreement and General Release is made and entered into by and between CYTORI THERAPEUTICS, INC. (Company) and JOHN K. FRASER.

WHEREAS, JOHN K. FRASER has been employed by CYTORI THERAPEUTICS, INC. in the one of the following capacities since November 14, 2002: Vice-President of Stem Cell Banking and Technology; Vice President of Research and Technology - Biologics and Vice President of Research and Technology - - Regenerative Cell Technology;

WHEREAS, for sound business reasons and in the best interests of JOHN K. FRASER and the Company, the Company and JOHN K. FRASER have agreed to end JOHN K. FRASER's employment with the Company effective 7-15-05;

WHEREAS, JOHN K. FRASER and the Company do not anticipate that there

will be any disputes between them or legal claims arising out of JOHN K. FRASER's Separation from the Company, the parties nevertheless desire to ensure a completely amicable parting and to settle fully and finally any and all differences or claims that might otherwise arise out of JOHN K. FRASER's employment with the Company relative to the termination of his employment;

NOW, THEREFORE, in consideration of the mutual promises contained herein, it is agreed as follows:

1. **Separation from Employment Relationship**. The employment relationship shall terminate and cease as of July 15, 2005 (Separation Date).

2. **Consideration**. In consideration of this Separation Agreement and General Release, Company agrees as follows: (i) to pay JOHN K. FRASER's COBRA premiums for himself, his wife and children for continued coverage under Company's group health plan for a period of six months, and (ii) the Company shall accelerate and vest 21,349 of JOHN K. FRASER's unvested stock options as of the Effective Date, and shall extend the exercise term for such accelerated options, and for 80,855 of JOHN K. FRASER's previously vested shares (for a total of 102,204 stock options) for a period of two years from the Effective Date of this Agreement; after which all such rights shall immediately terminate.

3. **Confidentiality**. The parties understand and agree that this Agreement, and the matters discussed in negotiating its terms, are entirely confidential. It is therefore expressly understood and agreed that JOHN

K. FRASER will not reveal, discuss, publish or in any way communicate any of the terms, amount or fact of this Agreement to any person, organization or other entity, except as may be required by law and except to Employee's immediate family members and professional representatives, who shall be informed of and bound by this confidentiality clause. It is also agreed and understood that Company may make any disclosure of the terms of the agreement as may be required by law.

4. **Release of Claims**. JOHN K. FRASER, for himself and his heirs, successors and assigns, does hereby agree to waive, release, acquit and forever discharge Company, and Company's parents, subsidiaries, affiliates, and related entities or companies, and all past and present officers, directors, shareholders, employees, agents, partners, attorneys, heirs, successors, and assigns, (hereinafter "Released Parties") from any and all claims, actions, charges, complaints and causes of action (hereinafter collectively referred to as "claims"), of whatever nature, whether known or unknown, which exist or may exist on JOHN K. FRASER's behalf against Released Parties as of the date of this Agreement, including but not limited to any and all tort claims, contract claims, wage claims, commission claims, bonus claims, overtime claims, wrongful termination claims, public policy claims, retaliation claims, statutory claims, personal injury claims, emotional distress claims, privacy claims, defamation claims, fraud claims, and any and all claims arising under any federal, state or other governmental statute, law, regulation or ordinance relating to employment, including but not limited to Title VII of the Civil Rights Act of 1964, as amended, the Americans with Disabilities Act, the Age Discrimination in Employment Act, the Family and Medical Leave Act, the Fair Labor Standards Act, the Employee Retirement Income Security Act, the California Labor Code, and the California Fair Employment and Housing Act covering discrimination in employment, including race, color, religious creed, national origin, ancestry, physical or mental disability, medical condition, marital status, military status, family care leave, pregnancy, sex, sexual orientation, age, and harassment or retaliation.

5. **Waiver of Rights Under Section 1542**. It is further understood and agreed that JOHN K. FRASER hereby expressly waives and relinquishes any and all claims, rights or benefits that he may have under California Civil Code section 1542, which provides as follows:

> **"A general release does not extend to claims which the creditor does not know or suspect to exist in his favor at the time of executing the release which if known by his must have materially affected his settlement with the debtor."**

In connection with such waiver and relinquishment, JOHN K. FRASER acknowledges that he may hereafter discover claims or facts in addition to or different from those which he now knows or believes to exist with respect to the matters released herein, and he expressly agrees to fully, finally and forever settle and release any and all claims, known or unknown, suspected or unsuspected, which exist or may exist on his behalf against the Released Parties at the time of execution of this Agreement, including, but not limited to, any and all claims relating to or arising from his employment with Company or the termination of that employment.

6. **Continuing Obligations Regarding Confidential or Proprietary Information**. JOHN K. FRASER agrees to abide by all the surviving provisions of the Employment, Confidentiality, and Assignment Agreement which he executed on November 13, 2002, including but not limited to, promises to protect all confidential and proprietary information of Company.

7. **Release Of Age Discrimination Claims**. JOHN K. FRASER agrees to the release of all known and unknown claims, including expressly the waiver of any rights or claims arising out of the Federal Age Discrimination in Employment Act ("ADEA") 29 U.S.C. § 621, et seq., and in connection with such waiver:

a. JOHN K. FRASER is hereby advised to consult with an attorney prior to signing this Agreement.

b. JOHN K. FRASER shall have a period of twenty-one (21) days from the date of receipt of this Agreement in which to consider the terms of the Agreement. JOHN K. FRASER may at his option execute this Agreement at any time during the 21-day period.

c. JOHN K. FRASER may revoke this Agreement at any time during the first seven (7) days following his execution of this Agreement, and this Agreement shall not be effective or enforceable until the seven-day period has expired.

8. **Employer Property And Trade Secrets**. JOHN K. FRASER will return to Company any and all of its property and documents which he may have in his possession. Including but not limited to the following:

- Cameras, video equipment etc.
- Company Files and Information

JOHN K. FRASER further agrees never to disclose to any person or entity any confidential or proprietary information of or about Company, except upon the express authorization and consent of Company.

9. **COBRA**. JOHN K. FRASER hereby acknowledges that Company has advised him that pursuant to the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) he has a right to elect continued coverage under Company's group health plan, at his own expense, for a period of thirty six months from the date of his termination.

10. **Non-Disparagement**. Company and JOHN K. FRASER agree that JOHN K. FRASER will not at any time defame, disparage or impugn the reputation of Company or any employees of Company in any future communications with any third-party or entity. "Disparage," as used in this Agreement, means to make any statement, written or oral, that casts another party in a negative light of any kind, or implies or attributes any negative quality to another party.

11. **Liquidated Damages For Breach Of Non-Disparagement**. In the event JOHN K. FRASER breaches any component of the Non-Disparagement clause contained in the above Section 10 at any time, JOHN K. FRASER acknowledges and agrees that it would be impractical or extremely difficult to ascertain the amount of actual damages to Company. For this reason, JOHN K. FRASER agrees that any violation of the Non-Disparagement provision of this Agreement shall result in the imposition of liquidated damages, and not as a penalty, in the amount of Seven-Thousand Dollars ($7,000.00), per each occurrence, to be paid by JOHN K. FRASER to Company, which represents the reasonable compensation for the loss incurred because of the breach.

12. **Ownership of Claims.** JOHN K. FRASER represents and warrants that he is the sole and lawful owner of all rights, title and interest in and to all released matters, claims and demands as herein contained and that there has been no assignment or other transfer of any interest of any claim or demand which he may have against Company.

13. **Successors and Assigns.** It is further expressly understood and agreed by JOHN K. FRASER that this Agreement and all of its terms shall be binding upon each party's respective representatives, heirs, executors, administrators, successors and assigns.

14. **No Admission Of Wrongdoing.** This Agreement shall not in any way be construed as an admission by the released parties of any acts of wrongdoing whatsoever against JOHN K. FRASER or any other person.

15. **Entire Agreement.** This Agreement and Release sets forth the entire agreement between the parties hereto, and fully supersedes any and all prior agreements or understandings between the parties hereto pertaining to the subject matter hereof.

16. **Venue.** Any proceeding brought to enforce this agreement shall be brought in San Diego Co., CA.

17. **Construction.** If any provision herein shall be deemed void, invalid, unenforceable, or otherwise stricken, in whole or in part, this Agreement shall be deemed amended to delete or modify, as necessary, the offending provision or provisions and to alter the bounds thereof in order to render it valid and enforceable. The parties hereby agree to substitute a valid provision that will most closely approximate the economic/legal effect and intent of the invalid provision. The parties agree to execute any additional documents that may reasonably be necessary to effectuate the purposes of this agreement.

I HAVE READ AND CAREFULLY CONSIDERED THIS SEPARATION AGREEMENT AND GENERAL RELEASE, AND HAVE HAD A REASONABLE PERIOD OF TIME TO CONSIDER THIS AGREEMENT PRIOR TO SIGNING. COMPANY HAS INDICATED THAT I AM FREE TO DISCUSS THIS AGREEMENT WITH MY FAMILY AND HAVE IT REVIEWED BY MY ATTORNEY PRIOR TO SIGNING IF I SO DESIRE. I AM SIGNING THIS AGREEMENT FREELY AND VOLUNTARILY.

Signed: /s/ John K. Fraser Date: 7/15/05
JOHN K. FRASER

CYTORI THERAPEUTICS, INC.

Signed: /s/ Christopher Calhoun Date: 7/27/05
CHRISTOPHER CALHOUN
CEO

Exhibit 10.26

SETTLEMENT AGREEMENT

THIS SETTLEMENT AGREEMENT (this "Agreement") is made and entered into as of August 9, 2005 by and among MAST Biosurgery AG, a Swiss corporation ("MAST AG"), MAST Biosurgery, Inc., a Delaware corporation and a wholly-owned subsidiary of MAST AG ("MAST, Inc." and, together with MAST AG, "MAST"), and Cytori Therapeutics, Inc., a Delaware corporation formerly incorporated under the name MacroPore Biosurgery, Inc. ("Cytori" and, together with MAST AG and MAST, Inc., the "parties"). Capitalized terms used but not defined herein shall have the respective meanings attributed to such terms in the Asset Purchase Agreement, by and between MAST AG and MacroPore Biosurgery, Inc., dated as of May 7, 2004 (as the same has subsequently been amended through the date hereof, the "Asset Purchase Agreement").

WHEREAS, on June 2, 2005, MacroPore Biosurgery, Inc. filed with the American Arbitration Association under the Reference Number 50 180 T 00234 05 a demand for arbitration (the "Arbitration") asserting claims arising out of or relating to MAST's obligations under the Asset Purchase Agreement and related documentation (the "Demand");

WHEREAS, on June 23, 2005, MAST responded to the Demand by filing with the American Arbitration Association an answer and counterclaims arising out of or relating to MacroPore Biosurgery, Inc.'s obligations under the Asset Purchase Agreement and related documentation (the "Counterclaims");

WHEREAS, on June 30, 2005, MacroPore Biosurgery, Inc. and MAST AG executed a term sheet providing, among other things, for a partial settlement of the claims set forth in the Demand and in the Counterclaims and certain agreements in respect of MacroPore Biosurgery, Inc.'s Japanese Thin Film Business (as defined below); and

WHEREAS, on July 11, 2005, MacroPore Biosurgery, Inc. changed its corporate name to Cytori Therapeutics, Inc.

NOW THEREFORE, the Parties agree as follows:

1. Mutual Releases and Related Matters.

(a) Releases by Cytori. Cytori hereby irrevocably waives, relinquishes, fully and forever releases and discharges (i) any and all claims arising out of, or relating to, or in connection with, the matters set forth in the Demand (including, without limitation, any claims Cytori may have against MAST or any of MAST AG's or MAST Inc.'s directors, officers, employees, agents, affiliates, shareholders or subsidiaries in respect of MAST's obligations under Section 2.4(b) of the Asset Purchase Agreement), other than and excluding any such claims (collectively, the "Cytori Japan Claims") arising out of, or relating to, or in connection with, the development, manufacturing, marketing and sale of Field of Use Bioabsorbable Implants in the Territory of Japan (the "Japanese Thin Film Business") and (ii) any Liens and security interests granted to Cytori pursuant to Section 2.10 of the Asset Purchase Agreement.

(b) Release by MAST. MAST hereby irrevocably waives, relinquishes, fully and forever releases and discharges any and all claims it may have against Cytori or any of Cytori's directors, officers, employees, agents, affiliates, shareholders or subsidiaries arising out of, relating to, or in connection with, the matters set forth in the Counterclaims, other than and excluding any such claims (collectively, the "MAST Japan Claims") arising out of, or relating to, or in connection with, the Purchase Right (including, without limitation, MAST's claim that Cytori depleted the economic value of the Purchase Right) and the Japanese Thin Film Business.

(c) Korean Matters. Cytori shall use reasonable efforts to assist MAST in transitioning the distribution of Bioabsorbable Implants in Korea from Dongbang Healthcare Products Co., Ltd. ("Dongbang") to a Korean distributor designated by MAST by causing Dongbang to transfer any Authorizations to such new distributor. Such efforts by Cytori are not intended to include any obligation of Cytori representatives to travel to Korea for this specific purpose.

(d) Rights under the Asset Purchase Agreement. For the avoidance of doubt, any and all obligations of MAST pursuant to Section 2.4(b), 2.4(c) and 2.10 of the Asset Purchase Agreement shall be deemed satisfied in full and Cytori shall have no further rights under such provisions.

(e) Sublease. As promptly as practicable following the execution of this Agreement, the Parties shall enter into a sublease agreement for the premises currently occupied by MAST at 6749 Top Gun Street, San Diego, CA 92121, such sublease to be on terms reasonably acceptable to MAST and Cytori (the "Sublease"). For the avoidance of doubt, nothing in this Agreement shall be construed as a release of any rights or claims that any Party may have pursuant to the terms of the Sublease or currently unknown claims related to MAST's occupation of the Premises (e.g., related to environmental contamination or property damage).

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2. Certain Agreements Relating to the Japanese Thin Film Business.

(a) Negotiations in Respect of the Japanese Thin Film Business. Promptly following the execution hereof, MAST and Cytori shall negotiate in good faith regarding the acquisition by MAST of Cytori's Japanese Thin Film Business on terms and conditions mutually agreeable to MAST and Cytori (such period of negotiation, the "Negotiation Period"). Without limiting any rights to due diligence MAST may have pursuant to Section 2.12(e) of the Asset Purchase Agreement, Cytori acknowledges and agrees that MAST shall have the right, during such Negotiation Period, to conduct customary (with respect to substance and scope) business, legal and accounting due diligence in respect of Cytori's Japanese Thin Film Business, and MAST and Cytori shall cooperate with each other with respect to such due diligence; provided that, unless and until MAST and Cytori agree otherwise, neither MAST nor any of its officers, employees, equity holders or advisors (including, for the avoidance of doubt, Dr. Kai Deusch) shall, during such Negotiation Period, directly contact or interact with Senko, Cytori's regulatory advisors in Japan, the Japanese Ministry of Health, Labor and Welfare, or any of their respective employees or agents (collectively, the "Restricted Third Parties") and, provided, further, that it shall not be deemed a lack of good faith on Cytori's part if Cytori does not agree to any direct contact or interaction of Dr. Kai Deusch with any Restricted Third Party during the Negotiation Period. The Negotiation Period may be terminated at any time by either MAST or Cytori in its respective sole discretion by written notice to the other Party.

(b) Amendment to Business Development Agreement. The Business Development Agreement by and among MAST AG and Cytori, dated as of May 13, 2004 (the "Business Development Agreement"), shall hereby be amended by deleting, in their entirety, the provisions of Section 4.2 and Article 5 by replacing such provisions with the words "[intentionally omitted]."

(c) Following Expiration of the Negotiation Period. Upon termination of the Negotiation Period by either Party, MAST retains the right to pursue the MAST Japan Claims and Cytori retains the right to pursue the Cytori Japan Claims, in each case in accordance with and subject to the provisions of the Asset Purchase Agreement.

(d) Matters Relating to Cytori's Japan Study. Promptly after the execution of this Agreement, Cytori will provide to MAST a copy of the protocol of its proposed clinical study conducted in support of the Japanese Thin Film Business (the "Japan Study"). MAST shall have the right to comment on such protocol and Cytori shall consider any such comments. Until all or any part of the Japan Study becomes generally publicly available (other than through the fault of MAST), MAST will not contact or communicate with, or attempt to contact or communicate with any third person or institution participating in the Japan Study; provided that, notwithstanding the foregoing, MAST shall have the right to contact or communicate with any of its existing or prospective customers regarding matters unrelated to the Japan Study. MAST agrees to supply all Bioabsorbable Film Implants reasonably required for the conduct of the Japan Study; provided that MAST shall receive full credit (on a $50 per sheet basis) in respect of such supply upon the earlier to occur of (i) Cytori and MAST agreeing on a supply by MAST of Bioabsorbable Film Implants for the Territory of Japan or (ii) Cytori and MAST agreeing on the acquisition by MAST of Cytori's Japanese Thin Film Business.

3. Matters Pertaining to Pending Arbitration. As soon as reasonably practicable upon the execution of this Agreement, MAST and Cytori shall dismiss all claims set forth in the Demand and in the Counterclaims in their entirety by notification in writing to the American Arbitration Association (the "AAA") case manager. Notwithstanding anything in this Agreement to the contrary, if the Parties fail to reach agreement regarding an acquisition by MAST of Cytori's Japanese Thin Film Business within the Negotiation Period, then, at any time following the termination of the Negotiation Period by either Party, MAST may reassert and pursue the MAST Japan Claims and Cytori may reassert and pursue the Cytori Japan Claims by filing the appropriate documentation with the AAA, provided that, if MAST so elects to assert and pursue any MAST Japan Claims, the arbitral tribunal shall make a determination as to whether MAST or Cytori is the prevailing party in such arbitration and, if MAST is so found to be the prevailing party, Cytori shall promptly reimburse MAST for any filing fees paid by MAST to the AAA (up to a maximum amount of $10,000) in connection with any such filing. In determining the "prevailing party" for purposes of the foregoing sentence, the amount of damages awarded, if any, shall not be the determinative factor.

4. Certain Representations and Warranties. Each of MAST, Inc. and Cytori represents and warrants that it is a corporation duly formed, validly existing and in good standing under the laws of the State of Delaware. MAST AG represents and warrants that it is a corporation duly formed, validly existing and in good standing under the laws of Switzerland. Each Party further represents and warrants that it has all necessary power and authority to enter into this Agreement to carry out the transactions contemplated herein, that all actions required to be taken by or on behalf of such Party to authorize it to execute, deliver and perform its obligations under this Agreement have been taken, and that this Agreement constitutes the legal, valid and binding obligation of such Party, enforceable against such Party in accordance with its terms, except as the same may be affected by bankruptcy, insolvency, moratorium or similar laws, or by legal or equitable principles relating to or limiting the rights of contracting parties generally. Each Party further represents and warrants that it currently has no actual knowledge of claims against any other Party hereto beyond those set forth in the Demand and the Counterclaims, respectively; provided that this representation and warranty shall not be construed as prohibiting either Party from pursuing or asserting any claims that have not been released by such Party in accordance with Section 1 hereof or of which such Party acquires knowledge after the date hereof.

5. Miscellaneous.

(a) No Admission. This Agreement represents a compromise of disputed claims, and it shall not be construed as an admission or any evidence that any Party hereto has breached any obligation.

(b) Further Assurances. The parties shall execute such documents and do such other things and acts as may be necessary to perform and fully carry out the terms and purposes of this Agreement, including, without limitation, all such documents and other things and acts that may be necessary to release any Liens or security interests that Cytori may have in respect of any intellectual property of MAST.

(c) Application of Agreement Only to the Parties. Subject to Section 5(i) below, this Agreement is intended to confer rights and benefits only on the Parties and their respective directors, officers, employees, agents, affiliates, shareholders or subsidiaries, and only with respect to the matters described in it.

(d) Breach of Terms of this Agreement. It is understood and agreed that the releases contained in Section 1 shall not be construed to include any claims that may arise between the Parties for breach of the terms of this Agreement. Nothing in this Agreement shall bar the Parties from enforcing their respective rights as provided herein.

(e) Advice of Counsel. This Agreement is the product of informed negotiations. The Parties acknowledge that they have been represented by counsel of their own choosing in connection with the negotiation and drafting of this Agreement. The language used in this Agreement shall be deemed to be language chosen by the Parties hereto to express their mutual intent.

(f) Entire Agreement. This Agreement constitutes and comprises the complete and entire agreement among the Parties, and fully expresses the intentions of the Parties. All agreements, covenants, representations and warranties, of any kind or nature, express or implied, oral or written, made by the Parties or their attorneys concerning this Agreement are fully set forth, expressed and contained herein. All prior and contemporaneous conversations, negotiations, term sheets, possible and alleged agreements, representations, covenants, and warranties concerning this Agreement are merged herein, and except as expressly set forth herein, all such prior and contemporaneous conversations, negotiations, possible and alleged agreements, representations, covenants, warranties or omissions concerning the subject matter hereof are null, void, unenforceable, immaterial, and have not been relied upon in any way by any Party hereto.

(g) Confidentiality. The letter agreement by and between MAST and MacroPore Biosurgery, Inc., dated June 22, 2005, shall govern this Agreement, the good faith negotiations and due diligence contemplated by Section 2(a) above, and MAST'S review of the Japan Study; provided that either Cytori shall have the right to disclose the terms of the Agreement as required by applicable security laws.

(h) Governing Law; Arbitration. This Agreement shall be governed by and interpreted in accordance with the laws of the State of California, including all matters of construction, validity, performance and enforcement, without giving effect to principles of conflict of laws and without application of the United Nations Convention for the International Sale of Goods. Any dispute arising out of or relating to this Agreement (including the formation, interpretation or alleged breach thereof) shall be settled by final and binding arbitration conducted under the auspices of, and in accordance with, the Commercial Arbitration Rules of the American Arbitration Association, by a tribunal of three arbitrators in San Francisco, California. The results of such

arbitration proceedings shall be binding upon the Parties hereto, and judgment may be entered upon the arbitration award in any court having jurisdiction thereof. Notwithstanding the foregoing, either party may seek interim injunctive relief from any court of competent jurisdiction. Each of the Parties hereto expressly and irrevocably consents and submits to the non-exclusive jurisdiction of each state and federal court located in California in connection with any legal proceedings hereunder.

(i) Successors. This Agreement shall be binding upon, and inure to the benefit of, the Parties hereto, and each of them jointly and severally, and to each of their successors and assigns.

(j) Costs of Settlement. Except as otherwise expressly provided herein, MAST and Cytori shall each pay their own expenses (including, but not limited to, all compensation and expenses of counsel) incident to this Agreement and the preparation for, and consummation of, the transactions provided for herein.

(k) Modification in Writing. No change or modification or termination of this Agreement shall be valid unless it is contained in a writing and signed by the Parties hereto.

(l) Counterparts. This Agreement may be executed in any number of counterparts, each of which shall be deemed an original and all of which together shall constitute one instrument. Delivery of signed counterparts by facsimile or other electronic means shall be fully as effective as if the original counterparts were executed and delivered.

(m) Asset Purchase Agreement and Business Development Agreement. The Asset Purchase Agreement and the Business

Development Agreement (each as amended or modified by this Agreement) shall remain in full force and effect.

(Remainder of page intentionally blank; signatures follow on next page)

IN WITNESS WHEREOF, this Agreement has been duly executed and delivered on behalf of the parties as of the date first above written.

MAST BIOSURGERY AG

By: /s/ Urs Felder
By: /s/ Corinne Welti
Its: Directors

MAST BIOSURGERY, INC.

By: /s/ Kai Deusch
Its: Secretary

CYTORI THERAPEUTICS, INC.

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

Exhibit 10.27

SEVERANCE AGREEMENT AND MUTUAL RELEASE

This Severance Agreement and Mutual Release ("Agreement") is made and entered into by and between CYTORI THERAPEUTICS, INC., formerly known as MACROPORE BIOSURGERY, INC. (the "Company") and SHARON SCHULZKI.

WHEREAS, SHARON SCHULZKI has been employed by the Company in one of the following capacities since July 17, 2000: Vice President of Marketing and Sales, Senior Vice President of Spine, and Chief Operating Officer;

WHEREAS, SHARON SCHULZKI was on a paid leave of absence effective June 22, 2005 and an unpaid leave of absence effective June 27, 2005;

WHEREAS, the parties have now decided to sever the employment relationship and SHARON SCHULZKI desires to receive enhanced severance pay in exchange for the releases contained in this Agreement;

WHEREAS, SHARON SCHULZKI and the Company desire to ensure a completely amicable parting and to settle fully and finally any and all differences or claims that might otherwise arise out of SHARON SCHULZKI's employment with the Company and the cessation of her employment;

NOW, THEREFORE, in consideration of the mutual promises contained herein, it is agreed as follows:

1. **Termination Of Employment Relationship.** The parties mutually agree that the employment relationship shall terminate and cease effective as of August 5, 2005 ("Termination Date").

2. **Consideration.** In consideration of this Agreement, CYTORI THERAPEUTICS, INC. agrees to pay SHARON SCHULZKI a lump sum of seven (7) times her monthly salary (total = $155,164.00) less standard tax and withholding requirements. The Company also agrees to allow SHARON SCHULZKI a two (2) year period of time from the Termination Date to exercise One Hundred Percent (100%) of her vested stock options, which equals Two Hundred Fifty Three Thousand, Seven Hundred Forty Three (253,743) options, upon the terms provided in the 1997 MACROPORE BIOSURGERY, INC. Stock Option and Stock Purchase Plan and the 2004 Equity Incentive Plan.

3. **Confidentiality.** The parties understand and agree that this Agreement, and the matters discussed in negotiating its terms, are entirely confidential. It is therefore expressly understood and agreed that SHARON SCHULZKI will not reveal, discuss, publish or in any way communicate any of the terms, amount or fact of this Agreement to any person, organization or other entity, except as may be required by law and except to SHARON SCHULZKI's immediate family members and professional representatives, who shall be informed of and bound by this confidentiality clause. It is also agreed and understood that the Company may make any disclosure of the terms of the agreement as may be required by law.

4. **Release Of Claims By Sharon Schulzki**. Except for the payments and benefits set forth in this Agreement, SHARON SCHULZKI, for herself and her heirs, successors and assigns, does hereby waive, release, acquit and forever discharge Company, and Company's parents, subsidiaries, affiliates, and related entities or companies, and all past and present officers, directors, shareholders, employees, agents, partners, attorneys, heirs, successors, and assigns, (hereinafter "Company Released Parties") from any and all claims, actions, charges, complaints and causes of action (hereinafter collectively referred to as "claims"), of whatever nature, whether known or unknown, which exist or may exist on SHARON SCHULZKI's behalf against Company Released Parties as of the date of this Agreement, including but not limited to any and all tort claims, contract claims, wage claims, commission claims, bonus claims, overtime claims, wrongful termination claims, public policy claims, retaliation claims, statutory claims, personal injury claims, emotional distress claims, privacy claims, defamation claims, fraud claims, and any and all claims arising under any federal, state or other governmental statute, law, regulation or ordinance relating to employment, including but not limited to Title VII of the Civil Rights Act of 1964, as amended, the Americans with Disabilities Act, the Age Discrimination in Employment Act, the Family and Medical Leave Act, the Fair Labor Standards Act, the Employee Retirement Income Security Act, the California Labor Code, and the California Fair Employment and Housing Act covering discrimination in employment, including race, color, religious creed, national origin, ancestry, physical or mental disability, medical condition, marital status, military status, family care leave, pregnancy, sex, sexual orientation, age, and harassment or retaliation.

5. **Release Of Claims By Cytori Therapeutics, Inc.** Except for the obligations of SHARON SCHULZKI set forth in this Agreement and the provisions of Sections 6 and 7, below, the Company, for itself and its parents, subsidiaries, affiliates, and related entities or companies, and all past and present officers, directors, shareholders, members, employees, agents, partners, attorneys, heirs, successors and assigns, does hereby waive, release, acquit and forever discharge SHARON SCHULZKI and her heirs, successors and assigns ("Schulzki Released Parties"), from any and all claims, actions, charges, complaints and causes of action (hereinafter collectively referred to as "claims"), of whatever nature, whether known or unknown, which exist or may exist against the Schulzki

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Released Parties as of the date of this Agreement, including but not limited to any and all tort claims, contract claims, defamation claims, breach of duty and/or loyalty claims, public policy claims, and any and all claims arising under any federal, state or other governmental statute, law, regulation or ordinance, except as provided below.

6. **Claims Not Released The Company.** Notwithstanding the release language set forth in Sections 5 and 7 by the Company, the releases described herein do not apply to any claims by the Company against SHARON SCHULZKI for theft, fraud, embezzlement, misappropriation of funds or trade secrets, or breach of confidentiality obligations by SHARON SCHULZKI. The Company is not presently aware of any such claims against SHARON SCHULZKI, but expressly reserves the right to bring such claims (if any), notwithstanding the release language contained in Sections 5 and 7 to the contrary.

7. **Waiver Of Rights Under Section 1542.** It is further understood and agreed by the parties hereto that each of them, as a condition of this Agreement (except as set forth in Section 6 above), hereby expressly waive and relinquish any and all claims, rights or benefits that she or it may have against the other under California Civil Code section 1542, which provides as follows:

> **"A general release does not extend to claims which the creditor does not know or suspect to exist in his or her favor at the time of executing the release which if known by him or her must have materially affected his or her settlement with the debtor."**

In connection with such waiver and relinquishment, each party hereby acknowledges that she or it or their respective attorneys may hereafter discover claims or facts in addition to, or different from, those which are now known or believed to exist, but that each party expressly agrees to fully, finally and forever settle and release any and all claims, known or unknown, suspected or unsuspected, which exist or may exist on their behalf against the other at the time of execution of this Agreement, including, but not limited to, any and all claims relating to or arising from SHARON SCHULZKI's employment with the Company or the termination of that employment, except for those claims identified in Section 6, above.

8. **Continuing Obligations Regarding Confidential Or Proprietary Information.** SHARON SCHULZKI agrees to abide by all the surviving provisions of the Employment, Confidentiality, and Assignment Agreement which she executed on July 18, 2000, including but not limited to, promises to protect all confidential and proprietary information of Company.

9. **Release Of Age Discrimination Claims.** SHARON SCHULZKI agrees to the release of all known and unknown claims, including expressly the waiver of any rights or claims arising out of the Federal Age Discrimination in Employment Act ("ADEA") 29 U. S. C. § 621, et seq., and in connection with such waiver:

a. SHARON SCHULZKI is hereby advised to consult with an attorney prior to signing this Agreement.
b. SHARON SCHULZKI shall have a period of twenty one (21) days from the date of receipt of this Agreement in which to consider the terms of the Agreement. SHARON SCHULZKI may at her option execute this Agreement at any time during the 21-day period.
c. SHARON SCHULZKI may revoke this Agreement at any time during the first seven (7) days following her execution of this Agreement, and this Agreement shall not be effective or enforceable until the seven-day period has expired.

10. **Employer Property And Trade Secrets.** SHARON SCHULZKI will return to CYTORI THERAPEUTICS, INC. any and all of its property and documents which she may have in her possession. Including but not limited to the following:

- All computers and related accessories (printers, etc.)
- Cameras, video equipment, etc.
- Samples
- Literature

SHARON SCHULZKI further agrees never to disclose to any person or entity any confidential or proprietary information of or about CYTORI THERAPEUTICS, INC., except upon the express authorization and consent of Company.

11. **COBRA**. SHARON SCHULZKI hereby acknowledges that Company has advised her that pursuant to the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) she has a right to elect continued coverage under Company's group health plan, at her own expense, for a period of up to eighteen months from the date of her termination.

12. **Non-Disparagement.** Company and SHARON SCHULZKI agree that neither party will at any time defame, disparage or impugn the reputation of the other in any future communications with any third-party or entity. "Disparage," as used in this Agreement, means to make any statement, written or oral, that casts another party in a negative light of any kind, or implies or attributes any negative quality to another party.

13. **Liquidated Damages For Breach Of Non-Disparagement.** In the event SHARON SCHULZKI breaches any component of the Non-Disparagement clause contained in the above Section 12 at any time, SHARON SCHULZKI acknowledges and agrees that it would be impractical or extremely difficult to ascertain the amount of actual damages to Company. For this reason, SHARON SCHULZKI agrees that any violation of the Non-Disparagement provision of this Agreement shall result in the imposition of liquidated damages, and not as a penalty, in the amount of Seven-Thousand Dollars ($7,000.00), per each occurrence, to be paid by SHARON SCHULZKI to Company, which represents the reasonable compensation for the loss incurred because of the breach.

14. **Ownership Of Claims.** SHARON SCHULZKI represents and warrants that she is the sole and lawful owner of all rights, title and interest in and to all released matters, claims and demands as herein contained and that there has been no assignment or other transfer of any interest of any claim or demand which she may have against Company.

15. **Successors And Assigns.** It is further expressly understood and agreed by SHARON SCHULZKI that this Agreement and all of its terms shall be binding upon each party's respective representatives, heirs, executors, administrators, successors and assigns.

16. **No Admission Of Wrongdoing.** This Agreement shall not in any way be construed as an admission by the released parties of any acts of wrongdoing whatsoever against SHARON SCHULZKI or any other person.

17. **Entire Agreement.** This Agreement and Release sets forth the entire agreement between the parties hereto, and fully supersedes any and all prior agreements or understandings between the parties hereto pertaining to the subject matter hereof.

18. **Venue.** Any proceeding brought to enforce this agreement shall be brought in San Diego Co., CA.

19. **Construction.** If any provision herein shall be deemed void, invalid, unenforceable, or otherwise stricken, in whole or in part, this Agreement shall be deemed amended to delete or modify, as necessary, the offending provision or provisions and to alter the bounds thereof in order to render it valid and enforceable. The parties hereby agree to substitute a valid provision that will most closely approximate the economic/legal effect and intent or the invalid provision. The parties agree to execute any additional documents that may reasonably be necessary to effectuate the purposes of this agreement.

I HAVE READ AND CAREFULLY CONSIDERED THIS SEVERANCE AGREEMENT AND MUTUAL RELEASE, AND HAVE HAD A REASONABLE PERIOD OF TIME TO CONSIDER THIS AGREEMENT PRIOR TO SIGNING. CYTORI THERAPEUTICS, INC. HAS INDICATED THAT I AM FREE TO DISCUSS THIS AGREEMENT WITH MY FAMILY AND HAVE IT REVIEWED BY MY ATTORNEY PRIOR TO SIGNING IF I SO DESIRE. I AM SIGNING THIS AGREEMENT FREELY AND VOLUNTARILY.

Signed: /s/ Sharon Schulzki Date: 8/5/05

SHARON SCHULZKI

CYTORI THERAPEUTICS, INC.

Signed: /s/ Christopher Calhoun Date: 8/10/05

CHRISTOPHER CALHOUN
CEO

CYTORI THERAPEUTICS, INC.

CONSULTING SERVICES AGREEMENT

THIS CONSULTING SERVICES AGREEMENT ("Agreement") is entered into effective as of July 15, 2005 ("Effective Date") by and between CYTORI THERAPEUTICS, INC., a Delaware corporation with a principal place of business at 3020 Callan Road, San Diego, California 92121 ("Company"), and John K. Fraser, an individual ("Consultant").

1. Services.

1.1 Consultant agrees to perform such research and development consulting ("Services") as requested by Company, which may be modified from time to time as directed by Marc H. Hedrick or Christopher J. Calhoun. Consultant shall devote not less than 30 hours per week in performing the Services. Company and Consultant shall, from time to time but not less frequently than two times per week, confer about Services currently being performed and what Services that the Company desires to have performed within the next 3 to 5 days. During these conferences, which may take place in person or via teleconference, the Company and Consultant shall reach an agreement as to the nature, scope, timing and location of such future Services.

1.2 Upon Company's request, Consultant shall submit progress reports to Company of the Services to be provided under this Agreement. The progress reports shall include, at a minimum, the status of the Services, recommendations, the expected date of completion, estimated cost, explanation for any delays, problem reports and problem resolution plans.

1.3 Company may remove Consultant from any project or other assignment at any time without penalty or additional payment of any kind.

1.4 Consultant shall perform all Services in a careful, professional and workmanlike manner. Consultant will coordinate Services under the general direction of Marc H. Hedrick with respect to the results to be achieved by the Services. However, Consultant shall determine, in his sole discretion, the manner and means by which such Services shall be performed.

1.5 Consultant shall, while working on Company's premises: (i) observe Company's rules and policies relating to the security of, access to or use of such premises and confidential information; (ii) shall not be permitted to remove any property of Company or a third party supplier of Company from Company's premises without the prior written consent of Company.

1.6 Consultant may perform services for any third party so long as this Agreement is not breached (including but not limited to the provisions regarding confidentiality and ownership) and Consultant's ability to perform the Services required by this Agreement is not impaired; provided, however, that during the term of the Agreement (including any extensions thereof), Consultant shall not directly or indirectly provide consulting or any other type of service to any other company in the fields of adult stem cell or adipose tissue research and commercialization, including but not limited to adipose derived stem cells and other adipose tissues for regenerative medical applications. Consultant acknowledges and agrees that, notwithstanding any other provision of this Agreement, Company may terminate this Agreement immediately for any breach by Consultant of this Section in addition to all other rights and remedies Company may have and this Section shall survive such a termination.

1.7 Consultant shall comply with all applicable laws, regulations, ordinances and other governmental rules in performing under this Agreement.

2. Fees, Invoice and Payment, Expenses.

2.1 As full consideration for Consultant's performance of Services and assignment of rights under this Agreement: Company shall pay Consultant at a rate of $15,000 (Fifteen Thousand Dollars) per month.

2.2 Company reserves the right to require from Consultant waivers, releases and other documentation relating to amounts due Consultant hereunder before payment to Consultant.

2.3 Company shall pay Consultant in arrears, twice per month for the Services provided. All payments shall be made in US Dollars.

2.4 Company shall not be liable for payment of any expenses or other charges unless the charges shall have been expressly approved in writing by Company prior to Consultant's incurring the charges. Requests for reimbursement shall be in a form reasonably acceptable to Company and shall include adequate documentation of expenses for which reimbursement is sought.

2.5 Company's payment to Consultant shall not constitute acceptance of the corresponding Services and the payment shall be

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subject to adjustments and offset for failures of Consultant to meet the requirements in this Agreement as determined by Company.

2.6 Company shall reimburse any pre-approved travel expenses incurred by Consultant while rendering Services under this Agreement, provided the expenses are reasonable and necessary. Such expenses shall include reasonable and necessary travel (including coach class airfare for domestic travel), and lodging in connection with Services performed under this Agreement. Requests for reimbursement shall be in a form reasonably acceptable to Company and shall include adequate documentation of expenses for which reimbursement is sought. Payment of reimbursable travel expenses will be remitted by Company within thirty (30) days of receipt of such documentation from Consultant.

3. Ownership of Work Product.

3.1 As used in this Agreement, (a) the term "Work Product" means any and all methods, products, product improvements, product modifications, processes, diagram(s), data, databases, designs, documentation, specification, formulas, inventions, innovations, know-how, plans, procedures, recommendations, reports, techniques, writings of any nature and any other work developed, written, made, conceived or reduced to practice in the course of or arising out of the Services performed by or on behalf of Consultant under this Agreement; and (b) the term "IP Rights" means any and all patents and

patent applications (including any divisions, substitutions, continuations, continuations-in-part, reissues, reexaminations, or extensions), copyrights, trade secrets and other intellectual property and proprietary rights.

3.2 Both parties acknowledge and agree that all right, title and interest and ownership of any and all Work Product shall be made available to and shall reside in the Company. Inventions, and any patent or patent application, copyrights or other IP Rights shall be owned solely by Company.

3.3 During the term of this Agreement, and at any time thereafter, Consultant shall assist Company, upon request from Company (and, if requested after termination of this Agreement, with reasonable further compensation to Consultant) in taking any action that may be reasonably necessary to secure, perfect, register, maintain and defend Company's right, title and interest in the Work Product, including without limitation Company's IP Rights.

4. Term and Termination.

4.1 This Agreement commences on the Effective Date and shall continue for a period of six months from the Effective Date.

4.2 In addition, Company may terminate this Agreement upon thirty (30) days prior written notice to Consultant for any reason.

4.3 Upon any termination of this Agreement, Consultant shall cease performing any and all Services contemplated hereunder.

4.4 Upon any termination of this Agreement for any reason, Consultant shall, within five (5) days of the termination (or completion), return or otherwise provide to Company all of the Confidential Information (as defined below in Section 7. l), and any product, equipment or other materials provided by Company to Consultant. In addition, Consultant shall provide to Company or destroy (at Company's option) any and all documents, memoranda, notes, and other tangible embodiments, in electronic or non-electronic form, prepared by or on behalf of Consultant based on or which include Confidential Information to the extent necessary to remove all such Confidential Information from Consultant's possession or control. Upon Company's request, Consultant shall certify in writing that Consultant has complied with this Section 4.4. Consultant shall continue to keep all Company Confidential Information confidential.

4.5 Termination of this Agreement shall be in addition to any and all other legal rights that Company may have against Consultant, and all remedies shall be cumulative.

4.6 The following Sections shall survive any termination or expiration of this Agreement: Sections 1.7, 3, 4.4, 4.5, 4.6, 5, 6, 7 -15.

5. Warranties and Limitations of Liability.

5.1 Consultant represents and warrants that (i) the Services will be completed in a professional and workmanlike manner and shall comply in all respects with this Agreement; (ii) the Work Product does not and will not infringe any third party's IP Rights and are free from any liens, encumbrances or claims; and (iii) the Services shall be performed solely by Consultant who is fully authorized to lawfully work in the United States.

6. Indemnification.

6.1 Consultant shall defend, indemnify and hold Company, its affiliates and their respective directors, officers, employees, and agents harmless from and against any and all claims, actions, demands, suits, losses, liabilities, judgments, awards, expenses and costs (including, without limitation, reasonable attorneys' fees and expenses) (each a "Claim") arising out of or related in any way to: (i) an actual or alleged infringement or violation by the Services or Work Product of any third party's IP Right; (ii) any act or omission by Consultant under this Agreement; (iii) any breach by Consultant of any of his representations and warranties herein; and (iv) any actual or alleged violation by Consultant of any law, statute, regulation or ordinance.

7. Confidentiality and Nondisclosure.

7.1 As used in this Agreement, "Confidential Information" means any and all technical and non-technical information owned by or licensed to Company and disclosed or provided to Consultant, including without limitation the Work Product and information related to Company's past, current, future and proposed products and services, and information concerning Company's adult stem cell or adipose tissue research and commercialization, including but not limited to adipose derived stem cells and other adipose tissues for regenerative medical applications, research, purchasing, manufacturing, customer lists, business forecasts, sales and merchandising, and marketing plans and information. In addition, Confidential Information shall mean any third party's proprietary or confidential information disclosed to Consultant in the course of performance of any and all Services under this Agreement.

7.2 Company retains sole and exclusive ownership, right, title and interest in and to all of the Confidential Information. Consultant shall protect any Confidential Information disclosed under this Agreement by using the same degree of care as Consultant uses to protect his own trade secrets of a similar nature, but in any event no less than a reasonable standard of care.

7.3 Consultant will not, at any time during the term of this Agreement or thereafter, disclose any

Confidential Information to any third party or, except as provided under this Agreement, use any Confidential Information for its or their own benefit or for the benefit of any third party. Consultant shall promptly notify Company of any unauthorized use or disclosure of the Confidential Information.

7.4 Consultant acknowledges that (i) the restrictions and obligations contained in this Section 7 are reasonable and necessary to protect Company's legitimate interests; (ii) in the event of a violation of these restrictions or a breach of these obligations, remedies at law shall be inadequate and violation or breach may cause irreparable damages to Company within a short period of time; and (iii) Company shall be entitled to injunctive relief, without posting bond or other security, against Consultant for each and every violation or breach, provided the enjoined party is given lawful notice of the proceeding and an opportunity to appear.

8. Independent Contractors.

8.1 Consultant is an independent contractor. Nothing contained in this Agreement shall be deemed or construed to create a joint venture, partnership, principal-agent or employment relationship between the parties.

8.2 Unless otherwise expressly provided in this Agreement, each party shall be responsible for its own costs and expenses in performing under this Agreement.

8.3 Consultant shall bear and be solely responsible for (i) paying all travel, housing, and other expenses which Consultant may be entitled to receive in connection with performing under this Agreement except as otherwise expressly provided herein; and (ii) withholding, reporting and paying, as applicable, all federal, state and local income tax withholding, social security taxes, workers compensation, state unemployment, health or disability insurance, retirement benefits, or other similar benefits or taxes or levies, if any.

9. Assignment. Consultant agrees and acknowledges that all of his services are personal in nature. Consultant shall not, in whole or in part, assign his rights or delegate any duties under this Agreement without Company's prior written consent, which may be withheld in Company's sole discretion. Without limiting the generality of the foregoing, Consultant specifically agrees that he will not enter into any subcontract to furnish all or any portion of the Services without prior written approval fiom Company. Any attempted assignment or delegated duty without the required consent shall be void. Company may assign this Agreement. This Agreement shall be binding upon and inure to the benefit of the parties, their successors and permitted assigns.

10. 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.

11. Use of Name. Consultant agrees not to use Company's name or logo in any advertising or as a reference for any promotional purposes without Company's prior written consent.

12. Complete Agreement. This Agreement, including its Exhibits, supersede all prior and contemporaneous agreements and understandings between the parties, both oral and written, with respect to its subject matter and constitutes the complete agreement and understanding between the parties, unless modified in writing and signed by both parties.

13. Severability. If a court of competent jurisdiction holds any provision of this Agreement, or its application, invalid or unenforceable, that provision shall be amended to achieve as nearly as possible the same economic effect as the original provision, and the remainder of this Agreement shall remain in full force and effect.

14. Notices. Any notice required or permitted to be given by either party under this Agreement shall be in writing and shall be deemed effective when hand-delivered or sent by registered mail, return receipt requested or by confirmed facsimile transmission to the signatory of each party to this Agreement as specified in the first paragraph of this Agreement or other address as either party may specify to the other party in the future in conformity with this Section.

15. Miscellaneous.

15.1 Any and all rights and remedies of a party upon the other party's breach of or default under this Agreement (whether expressly conferred by this Agreement or otherwise) shall be deemed cumulative with and not exclusive of any other right or remedy conferred by this Agreement or by law or equity on the party, and the exercise of any one remedy shall not preclude the exercise of any other. No delay or failure by either party to act in the event of a breach or default hereunder shall be construed as a waiver of that or any succeeding breach or a waiver of the provision itself. The captions and headings appearing in this Agreement are for reference only and shall not be considered in construing this Agreement.

15.2 This Agreement may be executed in any number of counterparts, each of which shall be an original as against any party whose signature appears and all of which together shall constitute one and the same instrument.

15.3 In the event of litigation between the parties concerning this Agreement, the prevailing party shall be entitled to its reasonable attorneys' fees and costs.

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

CONSULTANT:	COMPANY:
	Cytori Therapeutics, Inc.
/s/ John K. Fraser	By: /s/ Christopher J. Calhoun
John K. Fraser, Ph.D	
	Name: Christopher J. Calhoun
	Title: CEO

EXHIBIT 15.1

Letter Re Unaudited Interim Financial Information

November 14, 2005

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

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

With respect to the subject registration statement, we acknowledge our awareness of the use therein of our report dated November 14, 2005 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.

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, 2005
/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, 2005
/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, 2005 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
Christopher J. Calhoun
Chief Executive Officer

Dated: November 14, 2005

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

Dated: November 14, 2005