Xcorporeal, Inc.
Form 10-Q
August 14, 2008

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

**FORM 10-Q**

**x** QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE QUARTERLY PERIOD ENDED **JUNE 30, 2008**

p TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE TRANSITION PERIOD FROM _____ TO _____

Commission file number **001-31608**

**XCORPOREAL, INC.**
(Exact name of small business issuer as specified in its charter)

| **Delaware** | **75-2242792** |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (IRS Employer Identification Number) |

**12121 Wilshire Blvd., Suite 350, Los Angeles, California 90025**
(Address of principal executive offices)

**(310) 923-9990**
(Issuer's telephone number)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company.

| | |
|---|---|
| o Large accelerated filer | o Accelerated filer |
| o Non-accelerated filer | x Smaller reporting company |

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

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

| Class | Outstanding as of August 6, 2008 |
| --- | --- |
| Common Stock, $0.0001 par value | 14,704,687 shares |

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## PART I — FINANCIAL INFORMATION

### ITEM 1. Financial Statements

**XCORPOREAL, INC.**
**(a Development Stage Company)**
**BALANCE SHEETS**

| | June 30, 2008 (Unaudited) | December 31, 2007 |
|---|---|---|
| **ASSETS** | | |
| Current | | |
| Cash and cash equivalents | $ 67,987 | $ 106,495 |
| Marketable securities, at fair value | 9,241,096 | 16,401,898 |
| Restricted cash | 67,873 | 68,016 |
| Prepaid Expenses & Other Current Assets | 361,425 | 408,303 |
| Total current assets | 9,738,381 | 16,984,712 |
| Property and equipment, net | 320,250 | 266,912 |
| Other assets | 892 | 922 |
| Total Assets | $ 10,059,523 | $ 17,252,546 |
| | | |
| **LIABILITIES** | | |
| Current | | |
| Accounts payable | $ 1,491,152 | $ 1,125,239 |
| Accrued professional fees | 1,371,905 | 425,228 |
| Accrued royalties | 208,333 | 83,333 |
| Accrued compensation | 140,946 | 196,541 |
| Accrued other liabilities | 105,075 | 68,946 |
| Payroll liabilities | 64,505 | 11,926 |
| Deferred rent | 38,309 | - |
| Other current liabilities | 115,400 | 115,400 |
| Total Current Liabilities | 3,535,625 | 2,026,613 |
| | | |
| **Commitments and contingencies** | | |
| | | |
| **STOCKHOLDERS' EQUITY** | | |
| Preferred Stock, $0.0001 par value, 10,000,000 shares authorized, none outstanding | - | - |
| | | |
| Common Stock, $0.0001 par value, 40,000,000 shares authorized, 14,704,687 and 14,372,472 outstanding on June 30, 2008 and December 31, 2007, respectively | 1,470 | 1,437 |
| Additional paid-in capital | 39,786,986 | 36,822,316 |
| Deficit accumulated during the development stage | (33,264,558) | (21,597,820) |
| Total Stockholders' Equity | 6,523,898 | 15,225,933 |
| Total Liabilities & Stockholders' Equity | $ 10,059,523 | $ 17,252,546 |

See accompanying notes to interim financial statements.

**XCORPOREAL, INC.**
**(a Development Stage Company)**
**STATEMENTS OF OPERATIONS**
**(Unaudited)**

| | Three Months Ended June 30, | | Six Months Ended June 30, | | May 4, 2001 (Date of Inception) to June 30, |
|---|---|---|---|---|---|
| | 2008 | 2007 | 2008 | 2007 | 2008 |
| Operating Expenses: | | | | | |
| Selling, general and administrative | $ 1,895,013 | $ 1,611,188 | $ 5,644,652 | $ 5,590,288 | $ 20,047,344 |
| Research and development | 3,473,480 | 1,482,037 | 6,205,972 | 2,688,134 | 14,634,464 |
| Depreciation and amortization | 26,076 | 3,862 | 48,584 | 5,383 | 80,850 |
| Loss before other income and income taxes | (5,394,569) | (3,097,087) | (11,899,208) | (8,283,805) | (34,762,658) |
| Interest and other income | 78,196 | 308,060 | 234,070 | 619,926 | 1,501,300 |
| Loss before income taxes | (5,316,373) | (2,789,027) | (11,665,138) | (7,663,879) | (33,261,358) |
| Income taxes | - | - | 1,600 | - | 3,200 |
| Net Loss | $ (5,316,373) | $ (2,789,027) | $ (11,666,738) | $ (7,663,879) | $ (33,264,558) |
| Basic and diluted loss per share | $ (0.36) | $ (0.20) | $ (0.81) | $ (0.54) | |
| Weighted average number of shares outstanding | 14,593,485 | 14,200,050 | 14,488,473 | 14,200,050 | |

See accompanying notes to interim financial statements.

**XCORPOREAL, INC.**
**(a Development Stage Company)**
**STATEMENTS OF CASH FLOWS**
**(Unaudited)**

| | Six Months Ended June 30, | | May 4, 2001 (Date of Inception) to June 30, |
|---|---|---|---|
| | **2008** | **2007** | **2008** |
| **Cash flows used in operating activities** | | | |
| Net Loss for the Period | $ (11,666,738) | $ (7,663,879) | $ (33,264,558) |
| | | | |
| **Adjustments to reconcile net loss to net cash (used in) operating activities:** | | | |
| Stock Based Compensation | 2,081,958 | 1,483,464 | 6,067,694 |
| Non-employee Stock Based Compensation | 84,745 | 2,795,124 | 5,164,665 |
| Common Stock Issuance for consulting services rendered | 798,000 | - | 896,000 |
| Depreciation | 48,554 | 5,383 | 80,742 |
| Net Change in assets and liabilities: | | | |
| Decrease (increase) in Prepaid Expenses & Other Current Assets | 46,878 | (80,640) | (361,425) |
| Decrease (increase) in Other Assets | 30 | - | (892) |
| Increase (decrease) in Accounts Payable and Accrued Liabilities | 1,470,703 | (815,824) | 3,344,543 |
| Increase in Deferred Rent | 38,309 | - | 38,309 |
| Increase in Other Current Liabilities | - | - | 115,401 |
| Net Cash Used in Operating Activities | (7,097,561) | (4,276,372) | (17,919,521) |
| | | | |
| **Cash Flows from Investing Activities** | | | |
| Capital Expenditures | (101,892) | (58,100) | (400,992) |
| Restricted Cash | 143 | (83,050) | (67,873) |
| Purchase of marketable securities | (8,598,102) | (25,000,000) | (33,598,102) |
| Sale of marketable securities | 15,758,904 | 2,323,422 | 24,357,006 |
| Net Cash Provided by (Used in) Investing Activities | 7,059,053 | (22,817,728) | (9,709,961) |
| | | | |
| **Cash Flows from Financing Activities** | | | |
| Capital Stock issued | - | - | 27,434,349 |
| Advances from related party | - | - | 64,620 |
| Additional Proceeds from the Sale of Common Stock in 2006 | - | - | 198,500 |
| Net Cash Provided by Financing Activities | - | - | 27,697,469 |
| | | | |
| Increase/(decrease) in cash during the period | (38,508) | (27,094,100) | 67,987 |
| Cash, beginning of the period | 106,495 | 27,440,987 | - |
| Cash, end of the period | $ 67,987 | $ 346,887 | $ 67,987 |
| | | | |
| Supplemental disclosure of cash flow information; cash paid for: | | | |

| | | | |
|---|---|---|---|
| Interest | $ - | $ - | $ - |
| Income taxes | $ 1,600 | $ - | $ 3,200 |

See accompanying notes to interim financial statements.

**XCORPOREAL, INC.**
**(a Development Stage Company)**
**STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIENCY)**
**For the Period May 4, 2001 (Inception) to June 30, 2008**
**(Unaudited)**

| | Common Stock Shares | Common Stock Amount | Additional Paid-in Capital | Deficit Accumulated During Development Stage | Total |
|---|---|---|---|---|---|
| Common stock issued for cash at $0.01 per share | 2,500,000 | $ 250 | $ 24,750 | | $ 25,000 |
| Net Loss for the year ended December 31, 2001 | | | | $ (40,255) | (40,255) |
| Balance as of December 31, 2001 | 2,500,000 | 250 | 24,750 | (40,255) | (15,255) |
| Common stock issued for cash at $0.05 per share | 1,320,000 | 132 | 65,868 | | 66,000 |
| Net Loss for the year ended December 31, 2002 | | | | (31,249) | (31,249) |
| Balance as of December 31, 2002 | 3,820,000 | 382 | 90,618 | (71,504) | 19,496 |
| Net Loss for the year ended December 31, 2003 | | | | (12,962) | (12,962) |
| Balance as of December 31, 2003 | 3,820,000 | 382 | 90,618 | (84,466) | 6,534 |
| Net Loss for the year ended December 31, 2004 | | | | (23,338) | (23,338) |
| Balance as of December 31, 2004 | 3,820,000 | 382 | 90,618 | (107,804) | (16,804) |
| Net Loss for the year ended December 31, 2005 | | | | (35,753) | (35,753) |
| Balance as of December 31, 2005 | 3,820,000 | 382 | 90,618 | (143,557) | (52,557) |
| Common stock issued for a licence rights at $0.0001 per share | 9,600,000 | 960 | 40 | | 1,000 |
| Capital stock cancelled | (3,420,000) | (342) | 342 | | - |
| Warrants granted for consulting fees | | | 2,162,611 | | 2,162,611 |
| Forgiveness of related party debt | | | 64,620 | | 64,620 |

| | | | | | |
|---|---|---|---|---|---|
| Common stock issued for cash at $7.00, net of placement fees of $2,058,024d | 4,200,050 | 420 | 27,341,928 | | 27,342,348 |
| Stock-based compensation expense | | | 264,251 | | 264,251 |
| Net loss for the period | | | | (4,380,212) | (4,380,212) |
| Balance as of December 31, 2006 | 14,200,050 | 1,420 | 29,924,410 | (4,523,769) | 25,402,061 |
| Capital stock cancelled | (200,000) | (20) | 20 | | - |
| Common stock issued pursuant to consulting agreement at $4.90 per share | 20,000 | 2 | 97,998 | | 98,000 |
| Recapitalization pursuant to merger | 352,422 | 35 | (37,406) | | (37,371) |
| Warrants granted for consulting services | | | 2,917,309 | | 2,917,309 |
| Stock-based compensation expense | | | 3,721,485 | | 3,721,485 |
| Additional Proceeds from the Sale of Common Stock in 2006 | | | 198,500 | | 198,500 |
| Net loss for the period | | | | (17,074,051) | (17,074,051) |
| Balance as of December 31, 2007 | 14,372,472 | 1,437 | 36,822,316 | (21,597,820) | 15,225,933 |
| Common stock issued as compensation for consulting services at $3.61 per share | 200,000 | 20 | 721,980 | | 722,000 |
| Warrants granted for consulting services | | | 75,489 | | 75,489 |
| Stock-based compensation expense | | | 1,121,118 | | 1,121,118 |
| Net loss for the period | | | | (6,350,365) | (6,350,365) |
| Balance as of March 31, 2008 | 14,572,472 | 1,457 | 38,740,903 | (27,948,185) | 10,794,175 |
| Common stock issued as compensation for consulting services at $3.80 per share | 20,000 | 2 | 75,998 | | 76,000 |
| Cashless exercise of warrants | 112,215 | 11 | (11) | | 0 |
| Warrants granted for consulting services | | | 9,256 | | 9,256 |
| Stock-based compensation expense | | | 960,840 | | 960,840 |
| Net loss for the period | | | | (5,316,373) | (5,316,373) |

| | | | | | |
|---|---|---|---|---|---|
| Balance as of June 30, 2008 | 14,704,687 | $ 1,470 | $ 39,786,986 | $ (33,264,558) | $ 6,523,898 |

See accompanying notes to interim financial statements.

**XCORPOREAL, INC.**
**(a Development Stage Company)**
**NOTES TO INTERIM FINANCIAL STATEMENTS**
**June 30, 2008**
**(Unaudited)**

**Note 1 — Interim Reporting**

While information presented in the accompanying interim financial statements is unaudited, it includes all adjustments, which are, in the opinion of management, necessary to present fairly the financial position, results of operations and cash flows for the interim period presented. Except for the accrual for the Licensor Expenses discussed in Note 11-License Agreement below, all adjustments are of a normal recurring nature. It is suggested that these interim financial statements be read in conjunction with our December 31, 2007 financial statements.

The results of operations for the period ended June 30, 2008 are not necessarily indicative of the results that can be expected for the year ended December 31, 2008.

**Note 2 — Nature of Operations and Going Concern Uncertainty**

On October 12, 2007, pursuant to a merger agreement with Xcorporeal, Inc. (referred to hereinafter as Operations), our newly-formed wholly-owned merger subsidiary, merged with and into Operations, which became our wholly-owned subsidiary and changed its name to “Xcorporeal Operations, Inc.” We changed our name from CT Holdings Enterprises, Inc. (CTHE) to “Xcorporeal, Inc.” and amended our certificate of incorporation and bylaws to read substantially as Operations. As a result, our authorized common stock changed from 60,000,000 shares to 40,000,000 common shares, and our authorized preferred stock changed from 1,000,000 shares to 10,000,000 shares, resulting in total authorized capital stock of 50,000,000 shares.

Immediately prior to the merger, we caused a one-for-8.27 reverse split of our common stock. Each share of Operations common stock was then converted into one share of our common stock. In addition, we assumed all outstanding Operations options and warrants to purchase Operations common stock.

In this merger, CTHE is considered to be the legal acquirer and Xcorporeal to be the accounting acquirer. As the former shareholders of Operations owned over 97% of the outstanding voting common stock of CTHE immediately after the merger and CTHE was a public shell company, Operations is considered the accounting acquirer and the transaction is considered to be a recapitalization of Operations.

Historical financial statements prior to the merger were restated to be those of Operations. The merger is accounted for as if it were an issuance of the common stock of Operations to acquire our net assets, accompanied by a recapitalization. Historical stockholders’ equity of Operations is retroactively restated for the equivalent number of shares received in the merger, after giving effect to the difference in par value with an offset to paid-in capital. The assets and liabilities of Operations are carried forward at their predecessor carrying amounts. Retained deficiency of Operations is carried forward after the merger. Operations prior to the merger are those of Operations. Earnings per share for periods prior to the merger are restated to reflect the number of equivalent shares received by Operations’s stockholders. The costs of the transaction will be expensed to the extent they exceed cash received from CTHE. References to "we," "us, "our" and the "company" after consummation of the merger include CTHE and Operations.

As a result of the merger, we transitioned to a development stage company focused on researching, developing and commercializing technology and products related to the treatment of kidney failure.

We expect to incur negative cash flows and net losses for the foreseeable future. Based upon our current plans, we believe that our existing cash reserves will not be sufficient to meet our operating expenses and capital requirements before we achieve profitability. Accordingly, we may seek to raise additional funds through public or private placement of shares of preferred or common stock or through public or private financing. Our ability to meet our cash obligations as they become due and payable will depend on our ability to sell securities, borrow funds, reduce operating costs or some combination thereof. We may not be successful in raising necessary funds on acceptable terms, or at all. As a result of these conditions, there is substantial doubt about our ability to continue as a going concern. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Upon receipt of the approximate $27.3 million raised through private placement, we strategically began our operating activities and research and development efforts which resulted in a net loss of $17.1 million in 2007 and $11.7 million in the six months ended June 30, 2008. In addition, we invested $25.0 million in high grade money market funds and marketable securities of which we sold $15.8 million of the investments, leaving a balance of $9.2 million as of June 30, 2008. The final product design of the PAK will be completed shortly and units will undergo final verification and validation prior to a 510(k) submission to the FDA for clinical use under direct medical supervision. We intend to submit this 510(k) filing during the fourth quarter of 2008. It generally takes 4 to 12 months from the date of a 510(k) submission to obtain clearance from the FDA, although it may take longer. We expect that our monthly expenditures will increase as we reduce our spending on research and development costs as well as labor and material costs relating to the Aubrey agreement, and shift resources towards developing a marketing plan for the PAK.

**Note 3 — Development Stage Company**

We are a development stage company, devoting substantially all of our efforts to the research, development and commercialization of kidney failure treatment technologies.

*Risks and Uncertainties*— We operate in an industry that is subject to intense competition, government regulation and rapid technological change. Our operations are subject to significant risk and uncertainties including financial, operational, technological, regulatory and other risks associated with a development stage company, including the potential risk of business failure.

**Note 4 - Legal Proceedings**

On December 1, 2006, Operations initiated arbitration against National Quality Care, Inc. (NQCI) for NQCI's failure to fully perform its obligations under the License Agreement dated September 1, 2006. On September 1, 2006, Operations also entered into a Merger Agreement with NQCI which contemplated that Operations would acquire NQCI as a wholly owned subsidiary pursuant to a triangular merger, or would issue to NQCI shares of common stock in consideration of the assignment of the technology relating to the WAK and other medical devices (the "Technology Transaction"). The merger was not consummated.

On June 9, 2008, the arbitrator issued an Interim Award granting specific performance of the Technology Transaction. The Interim Award stated that the total aggregate shares of stock to be received by NQCI at the Closing should equal 48% of all Operations shares outstanding as of the date of the Merger Agreement. On September 1, 2006, there were 10,000,000 shares of Operations common stock outstanding. Copies of the License Agreement and Merger Agreement are attached as exhibits to our amended current report on Form 8-K/A filed with the Securities and Exchange Commission on June 11, 2008.

On August 4, 2008, the arbitrator issued a Second Interim Award, stating that 9,230,000 shares of our common stock should be issued to NQCI to effectuate the Technology Transaction. The arbitrator found that, with the exception of shareholder approval, virtually all conditions to Closing the Technology Transaction have been waived. The award further states that, if we or our stockholders do not approve the issuance of our stock to effectuate the Technology Transaction, all of the Technology covered by the License will be declared the sole and exclusive property of NQCI, and the arbitrator will schedule additional hearings to address whether the PAK technology is included within that Technology, and whether NQCI is entitled to compensatory damages and the amount of damages, if any, under these circumstances. The arbitrator has also stated that NQCI is entitled to recover reasonable attorneys' fees. NQCI has filed a motion seeking $3.9 million in fees, which we have opposed. Each of the Interim Awards state that it is an interim award subject to further proceedings, and is not intended to be a final award subject to a motion to confirm before a court of competent jurisdiction.

The Second Interim Award also states that—contrary to the assertion made by NQCI in its current report on Form 8-K filed on June 10, 2008—the License Agreement will remain in full force and effect until the Technology Transaction closes or the arbitrator determines that it will never close. NQCI has made a claim for reimbursement of approximately $690,000 in expenses under the License Agreement which were accrued under "Accrued Professional Fees" as of June 30, 2008.

The above interim awards are not yet binding or final. Therefore, no liability for the above awards has been accrued as no reliable estimate can currently be made.

**Note 5 — Cash Equivalents and Marketable Securities**

We invest available cash in short-term commercial paper, certificates of deposit, money market funds, and high grade marketable securities. We consider any liquid investment with an original maturity of three months or less when purchased to be cash equivalents. Investments, including certificates of deposit with maturity dates greater than three months when purchased and which have readily determined fair values, are classified as available-for-sale investments and reflected in current assets as marketable securities at fair market value. Our investment policy requires that all investments be investment grade quality and no more than ten percent of our portfolio may be invested in any one security or with one institution. At June 30, 2008, all of our cash was held in high grade money market funds and marketable securities.

Restricted cash represents deposits secured as collateral for a bank credit card program.

**Note 6 — Fair Value Measurements**

Effective January 1, 2008, we adopted SFAS No. 157, “Fair Value Measurements,” (“SFAS 157”). SFAS 157 defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. This statement does not require any new fair value measurements; rather, it applies to other accounting pronouncements that require or permit fair value measurements. In February 2008, FSP FAS 157-2, “Effective Date of FASB Statement No. 157”, was issued, which delays the effective date of SFAS 157 to fiscal years and interim periods within those fiscal years beginning after November 15, 2008 for non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). We elected to defer the adoption of the standard for these non-financial assets and liabilities.

Fair value is defined under SFAS 157 as the price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market in an orderly transaction between market participants on the measurement date. SFAS 157 also establishes a three-level hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

Beginning January 1, 2008, assets and liabilities recorded at fair value in the balance sheet are categorized based upon the level of judgment associated with the inputs used to measure their fair value. Level inputs, as defined by SFAS 157, are as follows:

- Level I - inputs are unadjusted, quoted prices for identical assets or liabilities in active markets at the measurement date.

- Level II - inputs, other than quoted prices included in Level I, that are observable for the asset or liability through corroboration with market data at the measurement date.

- Level III - unobservable inputs that reflect management's best estimate of what market participants would use in pricing he asset or liability at the measurement date.

The following tables summarize fair value measurements by level at June 30, 2008 for assets and liabilities measured at fair value on a recurring basis:

| | **Level I** | **Level II** | **Level III** | **Total** |
|---|---|---|---|---|
| Cash and cash equivalents | $ 67,987 | $ - | $ - | $ 67,987 |
| Marketable securities: | | | | |
| Commercial paper | 3,787,047 | - | - | 3,787,047 |
| Corporate securities fixed rate | 660,336 | - | - | 660,336 |
| Money market fund | 4,793,713 | - | - | 4,793,713 |
| Restricted cash | 67,873 | - | - | 67,873 |
| Total assets | $ 9,376,956 | $ - | $ - | $ 9,376,956 |

Short-term investments classified as available-for-sale were as follows:

| | **Aggregate FairValue** | **June 30, 2008 Gross Unrealized** Gains / (Losses) | **Estimated Fair** Value |
|---|---|---|---|
| Commercial paper | 3,787,047 | - | 3,787,047 |
| Corporate securities fixed rate | 660,336 | - | 660,336 |
| Total | $ 4,447,383 | $ - | $ 4,447,383 |

Xcorporeal reviews impairments associated with the above in accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities," and FASB Staff Position FAS 115-1 and FAS 124-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments," to determine the classification of the impairment as temporary or other-than-temporary. Xcorporeal considers these investments not to be temporarily impaired as of June 30, 2008.

There were no gross unrealized gains or losses as of June 30, 2008.

**Note 7 - Property and Equipment**

Property and equipment consist of the following at June 30, 2008:

| | | |
|---|---|---|
| Property and equipment | $ | 400,992 |
| Accumulated depreciation | | (80,742) |
| Property and equipment, net | $ | 320,250 |

Depreciation expense for the three and six months ended June 30, 2008 and 2007 was $26,061 and $48,554, and $3,847 and $5,334, respectively.

**Note 8 - Leases**

As of February 22, 2008, we entered into a 5 year lease agreement and relocated our corporate office to a location in Los Angeles, CA. The total lease payments will be $1,096,878 over a 5 year period. As of June 30, 2008, our remaining total lease payments are $1,062,062.

The following is a schedule by years of future minimum lease payments required under the 5-year corporate office lease as of June 30, 2008:

| Year ending December 31: | | | |
|---|---|---|---|
| 2008 | $ | 104,448 | (1) |
| 2009 | | 215,859 | |
| 2010 | | 224,650 | |
| 2011 | | 233,528 | |
| 2012 | | 242,842 | |
| 2013 | | 40,735 | (2) |
| | | | |
| Total minimum payments required | $ | 1,062,062 | |

( 1 ) excludes lease payments made through June 30, 2008
( 2 ) initial term of the lease agreement ends February 2013

On May 15, 2008, we executed the second amendment to the sublease agreement for office and warehouse space from Aubrey Group, Inc. Pursuant to the amendment, we acquired additional office and warehouse space. In addition, our monthly sublease rent increased to $8,715 through December 31, 2008. As of June 30, 2008, our remaining total sublease payments are $52,288 for this one year sublease agreement.

**Note 9 — Interest Income**

Interest income of $82,226 and $234,694, and $308,060 and $619,926 was reported for the three and six months ended June 30, 2008 and 2007, respectively.

**Note 10 — Related Party Transactions**

Pursuant to a consulting agreement effective December 1, 2007, Daniel S. Goldberger, director, provides consulting services as interim Chief Executive Officer with a devotion of at least 80 hours per month of services. In consideration of the services, we shall pay Mr. Goldberger $15,000 per month during the first two months and $12,500 per month thereafter. The term of the services is effective December 1, 2007 and will continue on a month to month basis. From execution through June 30, 2008, Mr. Goldberger was compensated $92,500 for his services.

Our Chief Medical and Scientific Officer maintains an office located in Beverly Hills, California. Pursuant to a reimbursement agreement effective January 29, 2008, we reimburse 50% of the rental and 50% of his monthly parking. The term of the agreement commenced on April 23, 2007, the date of the office lease agreement, and continue until the date on which he ceases to use the remote office to perform his duties as our Chief Medical and Scientific Officer. From commencement through June 30, 2008, we reimbursed our Chief Medical and Scientific Officer $1,239 and $24,386 for 50% of the monthly parking and rental, respectively.

**Note 11 — License Agreement**

On August 31, 2006, we entered into a Contribution Agreement with a company whose sole managing member is our current Chairman. We issued 9,600,000 shares of common stock in exchange for (a) the right, title, and interest to the name “Xcorporeal” and related trademarks and domain names, and (b) the right to enter into a License Agreement with National Quality Care, Inc. (NQCI) dated September 1, 2006 pursuant to which we obtained the exclusive rights to the technology relating to our kidney failure treatment and other medical devices. Operations was a shell corporation prior to the transaction. We valued the License Agreement at the carry-over basis of $1,000. As consideration for being granted the License, we agreed to pay a minimum annual royalty of $250,000, or 7% of net sales. We recorded $458,333 in royalty expenses covering the minimum royalties from commencement of the License Agreement through June 30, 2008. The License Agreement expires in 2105. As of June 30, 2008, we made one payment of the minimum annual royalty of $250,000.

The License Agreement also stipulates the reimbursement of reasonable and necessary expenses incurred in the ordinary course of business consistent with past practices ("Licensor Expenses") until the Closing or the termination of the Merger Agreement. NQCI has made a claim for reimbursement of approximately $690,000 in expenses under the License Agreement which were accrued under "Accrued Professional Fees" as of June 30, 2008. See Note 4 - Legal Proceedings for further additional information related to this License Agreement.

**Note 12 — Stock Options and Warrants**

***Incentive Compensation Plan***

On October 12, 2007, we adopted the Xcorporeal, Inc. 2007 Incentive Compensation Plan and the related form of option agreement that are substantially identical to the 2006 Incentive Compensation Plan in effect at Operations immediately prior to the merger.

The plan authorizes the grant of stock options, restricted stock, restricted stock units and stock appreciation rights. Effective February 28, 2007, there are 3,900,000 shares of common stock reserved for issuance pursuant to the plan (subject to adjustment in accordance with the provisions of the plan). The plan will continue in effect for a term of up to ten years.

On October 12, 2007, we also assumed options to purchase up to 3,880,000 shares of common stock, net 450,000 of which have since been canceled or expired, that were granted by Operations under its 2006 Incentive Compensation Plan.

As of June 30, 2008, there were 137,500 optioned shares outstanding and 3,762,500 shares available under the 2007 Incentive Compensation Plan.

***Stock Options to Employees, Officer and Directors***

The Compensation Committee of our Board of Directors determines the terms of the options granted, including the exercise price, the number of shares subject to option, and the vesting period. Options generally vest over five years and have a maximum life of ten years.

In the three months ended June 30, 2008, we granted options to purchase an aggregate of 35,000 shares of common stock to three employees. The options vest over 5 years, are exercisable at $7.00 per share, and expire in 2018.

We reported $960,840 and $2,081,958 in stock-based compensation expense for employees, officers, and directors for the three and six months ended June 30, 2008, respectively. For the three and six months ended June 30, 2007, we reported $844,400 and $1,483,464 in stock-based compensation expense for employees, officers, and directors, respectively.

All compensation expense for stock options granted has been determined under the fair value method using the Black-Scholes option-pricing model with the following assumptions:

| | For the six months ended June 30, 2008 |
|---|---|
| Expected dividend yields | zero |
| Expected volatility | 136% |
| Risk-free interest rate | 3.53-3.81% |
| Expected terms in years | 10 years |

***Warrants and Stock Options to Non-Employees***

In the six months ended June 30, 2008, there were no issuance of warrants. However, there were cashless exercises of warrants in the three months ended June 30, 2008.

We reported $9,256 and $84,745 in stock-based compensation expense for consultants for the three and six months ended June 30, 2008, respectively. We reported $137,489 and $2,795,124 in stock-based compensation expense for consultants for the three and six months ended June 30, 2007, respectively.

Compensation for options granted to non-employees has been determined in accordance with SFAS No. 123R, EITF 96-18, and EITF 00-18, “Accounting for Equity Instruments that are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services.” Accordingly, compensation is determined using the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measured.

For options and warrants issued as compensation to non-employees for services that are fully vested and non-forfeitable at the time of issuance, the estimated value is recorded in equity and expensed when the services are performed and benefit is received as provided by Financial Accounting and Standards Board ("FASB") Emerging Issues Task Force No. 96-18 "Accounting For Equity Instruments That Are Issued To Other Than Employees For Acquiring or In Conjunction With Selling Goods Or Services."

All charges for warrants granted have been determined under the fair value method using the Black-Scholes option-pricing model with the following assumptions:

| | For the six months ended June 30, 2008 |
|---|---|
| Expected dividend yields | zero |
| Expected volatility | 136% |
| Risk-free interest rate | 2.36-4.69% |
| Expected terms in years | 4.30-9.37 years |

The following table shows the change in unamortized compensation expense for stock options and warrants issued to employees, officers, directors and non-employees during the six months ended June 30, 2008:

| | Stock Options and Warrants Outstanding | | Unamortized Compensation Expense |
|---|---|---|---|
| January 1, 2008 | 4,674,221 | $ | 18,228,742 |
| Granted in the period | 55,000 | | 207,447 |
| Forfeited in the period | (285,000) | | (1,355,844) |
| Expensed in the period | - | | (3,167,215) |
| Exercised in the period | (325,000) | (1) | - |
| June 30, 2008 | 4,119,221 | $ | 13,913,130 |

(1) The cashless exercises of the granted 325,000 warrant shares resulted in the issuance of an aggregate of 112,215 shares of our common stock.

| | Number of Options and Warrants | | Weighted Average Exercise Price |
|---|---|---|---|
| Stock Options and Warrants | | | |
| Balance at January 1, 2008 | 4,674,221 | $ | 6.01 |
| Granted | 55,000 | | 7.00 |
| Exercised | (325,000) | | 1.00 |
| Forfeited | (285,000) | | 7.00 |
| Balance at June 30, 2008 | 4,119,221 | $ | 6.35 |

**Note 13 — Stockholders' Equity**

On April 2, 2008, 20,000, shares of our common stock were granted as compensation for consulting services rendered to us.

On April 9, 2008, Consolidated National, LLC (CNL), a limited liability company whose managing member is our Executive Chairman, sold 3,167,404 shares of our common stock in a private placement. Approximately 230,000 shares were sold to our officers and directors. We did not receive any proceeds from this sale by or for the account of the selling stockholder.

On June 30, 2008, we issued an aggregate of 112,215 shares of our common stock pursuant to cashless exercise of warrants by three warrant holders.

**Note 14 — Product Development Agreement**

In July 2007, we entered into an agreement with Aubrey Group, Inc., an FDA-registered third-party contract developer and manufacturer of medical devices for the design and development of a Portable Artificial Kidney ("PAK"). The PAK will be designed for use as an Intermittent as well as a Continuous Renal Replacement Therapy (CRRT) in the hospital with medical supervision. The development is expected to be completed by the end of 2008 and projected labor and material costs are estimated at approximately $5.1 million over the term. The agreement can be terminated at any time with 30 business days notice. From commencement through June 30, 2008, we incurred $2,553,387 in expense for the services rendered under this agreement.

**Note 15 — Subsequent Events**

On August 4, 2008, we relocated our laboratory to our Irvine subleased facility.

On August 4, 2008, the arbitrator issued a Second Interim Award, stating that 9,230,000 shares of our common stock should be issued to NQCI to effectuate the Technology Transaction. The arbitrator found that, with the exception of shareholder approval, virtually all conditions to Closing the Technology Transaction have been waived. The award further states that, if we or our stockholders do not approve the issuance of our stock to effectuate the Technology Transaction, all of the Technology covered by the License will be declared the sole and exclusive property of NQCI, and the arbitrator will schedule additional hearings to address whether the PAK technology is included within that Technology, and whether NQCI is entitled to compensatory damages and the amount of damages, if any, under these circumstances. The arbitrator has also stated that NQCI is entitled to recover reasonable attorneys' fees.

**ITEM 2. Management's Discussion and Analysis or Plan of Operation.**

*The following discussion of our financial condition and results of operations should be read in conjunction with our financial statements and the related notes, and the other financial information included in this report.*

**Forward-Looking Statements**

This report contains "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995 with respect to the financial condition, results of operations, business strategies, operating efficiencies or synergies, competitive positions, growth opportunities for existing products, plans and objectives of management, markets for stock of Xcorporeal and other matters. Statements in this report that are not historical facts are "forward-looking statements" for the purpose of the safe harbor provided by Section 21E of the Exchange Act and Section 27A of the Securities Act. Such forward-looking statements, including, without limitation, those relating to the future business prospects, revenues and income of Xcorporeal, wherever they occur, are necessarily estimates reflecting the best judgment of the senior management of Xcorporeal on the date on which they were made, or if no date is stated, as of the date of this report. These forward-looking statements are subject to risks, uncertainties and assumptions, including those described in the "Risk Factors" described below, that may affect the operations, performance, development and results of our business. Because the factors discussed in this report could cause actual results or outcomes to differ materially from those expressed in any forward-looking statements made by us or on our behalf, you should not place undue reliance on any such forward-looking statements. New factors emerge from time to time, and it is not possible for us to predict which factors will arise. In addition, we cannot assess the impact of each factor on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements.

**Overview**

We are a medical device company developing an innovative *extra-corporeal* platform technology to be used in devices to replace the function of various human organs. These devices will seek to provide patients with improved, efficient and cost effective therapy. The platform leads to three initial products:

- A PAK for hospital Renal Replacement Therapy (RRT);
- A PAK for home hemodialysis; and
- A Wearable Artificial Kidney (WAK) for continuous ambulatory hemodialysis.

For the hospital market, we are developing a portable, multifunctional renal replacement device that will offer cost-effective therapy for those patients suffering from Acute Renal Failure (ARF) causing a rapid decline in kidney function. We have completed our functional prototype of the product, which is currently undergoing bench testing, and will submit a 510(k) filing with the FDA during the fourth quarter of 2008. We plan to commercialize the product after receiving approval from the FDA. Timing of FDA approval is uncertain at this time.

We also plan to commercialize a home hemodialysis device for the End Stage Renal Disease (ESRD) market, comprised of patients in whom the kidneys have ceased to function. We have also completed our functional prototype of the product, which is currently undergoing bench testing, and we will submit a 510(k) with the FDA during the second half of 2009. Clinical trials are anticipated to commence within 12 months.

Our WAK is a device for the chronic treatment of ESRD. We have successfully demonstrated a prototype system that weighs less than 6 kg., is battery operated, and can be worn by an ambulatory patient. We plan to continue our development of this product over the next 12 months**.**

We are a development stage company, have been unprofitable since our inception, and will incur substantial additional operating losses for at least the next twelve months as we continue to implement commercial operations and allocate significant and increasing resources to research, development, clinical trials and other activities. Accordingly, our historical operations and financial information are not indicative of our future operating results, financial condition or ability to operate profitably as a commercial enterprise.

**Research and Development**

***R&D Team***

We have recruited and currently employ a talented interdisciplinary team of scientists and engineers who are developing our products. The team includes engineering leaders from within the dialysis field who provide state of the art as well as historical insights into dialysis equipment. The team also includes seasoned engineers from related medical fields providing us with cutting edge technology in the areas of fluidics, sensors and electronics. In addition, we have retained a medical device consulting firm, The Aubrey Group, Inc., an FDA-registered third-party contract developer and manufacturer of medical devices, to provide engineering support in the development of the PAK. We will continue development of our products utilizing The Aubrey Group in conjunction with our existing team.

We incurred $3.5 million and $6.2 million in research and development costs in the three and six months ended June 30, 2008, respectively. This compares to $1.5 million and $2.7 million incurred in the three and six months ended June 30, 2007.

***Third-party Arrangements***

In July 2007, we entered into an agreement with Aubrey for the design and development of subsystems of the PAK. The PAK will be designed for intermittent hemodialysis or CRRT in a clinical setting as well as for treatments in a home setting. The development is expected to be complete by the end of 2008. Total labor and material costs over the term of the Aubrey agreement are budgeted at approximately $5.1 million, though we can terminate the agreement at any time with 30 business days notice.

We also contract with other third parties to assist in our research and development efforts and to supplement our internal resources while we continue to grow our organization.

**Management’s Discussion and Analysis**

***Results of Operations for the three and six months ended June 30, 2008.***

We have not generated any revenues since inception. We incurred a net loss of $5.3 million and $11.7 million for the three and six months ended June 30, 2008, respectively, compared to a net loss of $2.8 million and $7.7 million for the three and six months ended June 30, 2007, respectively. The increase in net loss was primarily due to (i) research, development and other expenses related to advancing our kidney failure treatment technologies, (ii) stock compensation expense related to options and warrants granted to directors, officers, employees, and consultants, (iii) legal fees, and (iv) increased company personnel. At June 30, 2008, we had positive working capital of $6.2 million compared to positive working capital of $15.0 million at the beginning of the year.

***Liquidity and Capital Resources***

We expect to incur operating losses and negative cash flows for the foreseeable future. During the fourth quarter 2006, we raised approximately $27.3 million (net of placement fees of $2.1 million) through a private placement. Our ability to execute on our current business plan is dependent upon our ability to develop and market our products, and, ultimately, to generate revenue.

As of June 30, 2008, we had cash, cash equivalents and marketable securities of approximately $9.3 million. We are currently expending cash at a rate of approximately $1.2 million per month. In addition, we may become obligated to pay damages, costs or legal fees in connection with the ongoing arbitration described under Part II, Item 1. Legal Proceedings, in amounts yet to be determined. At present rates, we will have to raise additional funds during the next twelve months. We may not be successful in doing so on terms acceptable to us, and the inability to raise capital could require us to curtail our current plans in order to decrease spending, which could have a material adverse effect on our plan of operation. Our ability to execute on our current business plan is dependent upon our ability to obtain equity financing, develop and market our products, and, ultimately, to generate revenue.

We expect to incur negative cash flows and net losses for the foreseeable future. Based upon our current plans, we believe that our existing cash reserves will not be sufficient to meet our operating expenses and capital requirements before we achieve profitability. Accordingly, we may seek to raise additional funds through public or private placement of shares of preferred or common stock or through public or private financing. Our ability to meet our cash obligations as they become due and payable will depend on our ability to sell securities, borrow funds, reduce operating costs or some combination thereof. We may not be successful in raising necessary funds on acceptable terms, or at all. As a result of these conditions, there is substantial doubt about our ability to continue as a going concern. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Upon receipt of the approximate $27.3 million raised through private placement, we strategically began our operating activities and research and development efforts which resulted in a net loss of $17.1 million in 2007 and $11.7 million in the six months ended June 30, 2008. In addition, we invested $25.0 million in high grade money market funds and marketable securities of which we sold $15.8 million of the investments, leaving a balance of $9.2 million as of June 30, 2008. The final product design of the PAK will be completed shortly and units will undergo final verification and validation prior to a 510(k) submission to the FDA for clinical use under direct medical supervision. We intend to submit this 510(k) filing during the fourth quarter of 2008. It generally takes 4 to 12 months from the date of a 510(k) submission to obtain clearance from the FDA, although it may take longer. We expect that our monthly expenditures will increase as we reduce our spending on research and development costs as well as labor and material costs relating to the Aubrey agreement, and shift resources towards developing a marketing plan for the PAK.

**Research and Development**

We employ an interdisciplinary team of scientists and engineers who are developing the PAK and a separate, interdisciplinary team developing the WAK. In addition, we have retained Aubrey to assist with the engineering of the PAK. The PAK will be engineered to perform both hemodialysis, hemofiltration and ultrafiltration under direct medical supervision. A variation of this device will be developed for chronic home hemodialysis. An initial prototype of the PAK, capable of performing the functions of a hemodialysis machine, and demonstrating our unique new fluidics circuit, was completed at the end of 2007. Further refinements to this prototype including the addition of safety sensors and electronic controls is now in progress. The final product design of the PAK will be completed shortly and units will undergo final verification and validation prior to a 510(k) submission for clinical use under direct medical supervision. A clinical study is not required for this submission.

In a clinical feasibility study conducted in London in March 2007, a research prototype of the WAK was successfully demonstrated in eight patients with end-stage renal disease. Patients were successfully treated for up to 8 hours with adequate clearances of urea and creatinine. The device was well tolerated and patients were able to conduct activities of normal daily living including walking and sleeping. There were no serious adverse events although clotting of the dialyzer occurred in two patients. To our knowledge, this is the first successful demonstration of a wearable artificial kidney in man. This year we are making substantial improvements to the WAK. These include improvement of the heparin pumping system intended to address the dialyzer clotting problem, the addition of safety sensors required for commercial dialysis equipment, the addition of electrical controls to provide a convenient user interface, improvements to the blood flow circuit and further miniaturization of the device to improve fit to the human body. Additional clinical studies will be conducted upon completion of the prototype

We incurred $3.5 million and $6.2 million in research and development costs in the three and six months ended June 30, 2008, respectively. This compares to $1.5 million and $2.7 million incurred in the three and six months ended June 30, 2007.

**Contractual Obligations and Commercial Commitments**

**Contractual Obligations and Commercial Commitments**

| Contractual Obligations: | Total | Less than 1 year | 1 - 3 years | 3 - 5 years | More than 5 years |
|---|---|---|---|---|---|
| **Capital Lease Obligations** | $ - | $ - | $ - | $ - | $ - |
| **Operating Lease Obligations (1)** | 1,264,424 | 194,649 | 786,199 | 283,576 | - |
| **Research & Development Contractual Commitments** | 162,148 | 162,148 | - | - | - |
| **Other Liabilities** | 97,167 | 97,167 | - | - | - |
| | $ 1,523,737 | $ 453,963 | $ 786,199 | $ 283,576 | $ - |

(1) Operating lease commitments for our corporate office facility, product development facility, Dr. Gura's office which is a related party transaction, and two corporate apartments.

The table excludes the agreement with Aubrey in relation to the PAK development which can be terminated at any time with 30 business days notice. Due to the successful rate of the development, we anticipate coming under the agreement's approximate budget of $5.1 million. With the expected completion by end of 2008, we estimate we will incur cost of $3.0 million for 2008 under this agreement.

**Off-Balance Sheet Arrangements**

As of June 30, 2008, we had no off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, results of operations or cash flows.

***Critical Accounting Policies and Estimates***

The discussion and analysis of our financial condition and results of operations is based upon our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. Generally accepted accounting principles require management to make estimates, judgments and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and the disclosure of contingent assets and liabilities. We base our estimates on experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that may not be readily apparent from other sources. Our actual results may differ from those estimates.

We consider our critical accounting policies to be those that involve significant uncertainties, require judgments or estimates that are more difficult for management to determine or that may produce materially different results when using different assumptions. We consider the following accounting policies to be critical:

*Marketable Securities*

We classify investments with maturity dates greater than three months when purchased as marketable securities. Investments, including certificates of deposit with maturity dates greater than three months when purchased and which have readily determined fair values, are classified as available-for-sale investments and reflected in current assets as marketable securities at fair market value. Our investment policy requires that all investments be investment grade quality and no more than ten percent of our portfolio may be invested in any one security or with one institution.

Short-term investments classified as available-for-sale were as follows:

| | | **June 30, 2008** | | |
|---|---|---|---|---|
| | **Aggregate Fair Value** | **Gross Unrealized Gains / (Losses)** | | **Estimated Fair Value** |
| Commercial paper | 3,787,047 | - | | 3,787,047 |
| Corporate securities fixed rate | 660,336 | - | | 660,336 |
| Total | $ 4,447,383 | $ - | $ | 4,447,383 |

Xcorporeal reviews impairments associated with the above in accordance with SFAS No. 115, “Accounting for Certain Investments in Debt and Equity Securities,” and FASB Staff Position FAS 115-1 and FAS 124-1, “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments,” to determine the classification of the impairment as temporary or other-than-temporary. Xcorporeal considers these investments not to be temporarily impaired as of June 30, 2008.

There were no gross unrealized gains or losses as of June 30, 2008.

*Stock-Based Compensation*

Statements of Financial Accounting Standards (SFAS) No. 123 (revised 2004), *Share-Based Payment* , (SFAS 123(R)) and Securities and Exchange Commission issued Staff Accounting Bulletin (SAB) No. 107 (SAB 107) require the measurement and recognition of compensation expense for all share-based payment awards made to

employees and directors based on estimated fair values. We have applied the provisions of SAB 107 in our adoption of SFAS 123(R).

In determining stock based compensation, we consider various factors in our calculation of fair value using a Black-Scholes pricing model. These factors include volatility, expected term of the options and forfeiture rates. A change in these factors could result in differences in the stock based compensation expense.

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

We invest our cash in short term high grade commercial paper, certificates of deposit, money market accounts, and marketable securities. We consider any liquid investment with an original maturity of three months or less when purchased to be cash equivalents. We classify investments with maturity dates greater than three months when purchased as marketable securities, which have readily determined fair values and are classified as available-for-sale securities. Our investment policy requires that all investments be investment grade quality and no more than ten percent of our portfolio may be invested in any one security or with one institution.

Investments in both fixed rate and floating rate interest earning instruments carry a degree of interest rate risk arising from changes in the level or volatility of interest rates; however, interest rate movements do not materially affect the market value of our portfolio because of the short-term nature of these investments. A reduction in the overall level of interest rates may produce less interest income from our investment portfolio. The market risk associated with our investments in debt securities is substantially mitigated by the frequent turnover of our portfolio.

**ITEM 4. Controls and Procedures**

We conducted an evaluation, under the supervision and with the participation of our Executive Chairman (principal executive officer) and Chief Financial Officer (principal financial officer), of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act) as of June 30, 2008. Based upon this evaluation, our Executive Chairman and Chief Financial Officer concluded that our disclosure controls and procedures were effective to ensure that required material information is included in this quarterly report for the period ended June 30, 2008.

There were no changes in our internal control over financial reporting during the quarter ended June 30, 2008 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II — OTHER INFORMATION

### ITEM 1. Legal Proceedings.

On December 1, 2006, Operations initiated arbitration against National Quality Care, Inc. (NQCI) for NQCI's failure to fully perform its obligations under the License Agreement dated September 1, 2006. On September 1, 2006, Operations also entered into a Merger Agreement with NQCI which contemplated that Operations would acquire NQCI as a wholly owned subsidiary pursuant to a triangular merger, or would issue to NQCI shares of common stock in consideration of the assignment of the technology relating to the WAK and other medical devices (the "Technology Transaction"). The merger was not consummated.

On June 9, 2008, the arbitrator issued an Interim Award granting specific performance of the Technology Transaction. The Interim Award stated that the total aggregate shares of stock to be received by NQCI at the Closing should equal 48% of all Operations shares outstanding as of the date of the Merger Agreement. On September 1, 2006, there were 10,000,000 shares of Operations common stock outstanding. Copies of the License Agreement and Merger Agreement are attached as exhibits to our amended current report on Form 8-K/A filed with the Securities and Exchange Commission on June 11, 2008.

On August 4, 2008, the arbitrator issued a Second Interim Award, stating that 9,230,000 shares of our common stock should be issued to NQCI to effectuate the Technology Transaction. The arbitrator found that, with the exception of shareholder approval, virtually all conditions to Closing the Technology Transaction have been waived. The award further states that, if we or our stockholders do not approve the issuance of our stock to effectuate the Technology Transaction, all of the Technology covered by the License will be declared the sole and exclusive property of NQCI, and the arbitrator will schedule additional hearings to address whether the PAK technology is included within that Technology, and whether NQCI is entitled to compensatory damages and the amount of damages, if any, under these circumstances. The arbitrator has also stated that NQCI is entitled to recover reasonable attorneys' fees. NQCI has filed a motion seeking $3.9 million in fees, which we have opposed. Each of the Interim Awards state that it is an interim award subject to further proceedings, and is not intended to be a final award subject to a motion to confirm before a court of competent jurisdiction.

The Second Interim Award also states that—contrary to the assertion made by NQCI in its current report on Form 8-K filed on June 10, 2008—the License Agreement will remain in full force and effect until the Technology Transaction closes or the arbitrator determines that it will never close. NQCI has made a claim for reimbursement of approximately $690,000 in expenses under the License Agreement which were accrued under "Accrued Professional Fees" as of June 30, 2008.

The above interim awards are not yet binding or final. Therefore, no liability for the above awards has been accrued as no reliable estimate can currently be made.

### ITEM 1A. Risk Factors.

*Investing in our common stock involves a high degree of risk. In addition to the information in this report, you should carefully consider the risks described under Risk Factors in Part I, Item 1 of our Annual Report on Form 10-KSB for the year ended December 31, 2007, and the revised risk factors noted below. If any of such risks actually occurs, our business, results of operations and financial condition will likely suffer. As a result the trading price of our common stock may decline, and you might lose part or all of your investment*

**An unfavorable result in the pending arbitration could have a material adverse effect on our capital structure, business and financial condition.**

We consider the protection of our proprietary technology for treatment of kidney failure, which we have licensed and are developing, to be critical to our business prospects. We obtained the rights to the wearable artificial kidney (WAK) through a License Agreement with National Quality Care, Inc. (NQCI). On December 1, 2006 we initiated arbitration against NQCI for failure to fully perform its obligations under our License Agreement. NQCI filed counterclaims seeking to invalidate the License Agreement and claiming monetary damages against us. In interim awards, the arbitrator has found that the License Agreement will not survive if the Technology Transaction contemplated by the Merger Agreement entered into concurrently with the License Agreement fails to close. If this determination were upheld by a court of competent jurisdiction, we could be prevented from using the WAK technology we licensed from it. In addition, if it were found that our rights to the portable artificial kidney (PAK) are derived from licensed technology, that could significantly impact our ability to develop, manufacture and sell our PAK, which would have a material adverse effect on our business and results of operations.

The interim awards state that NQCI is entitled to reimbursement for reasonable attorneys' fees. NQCI has made a claim for approximately $3.9 million in such fees, which we have opposed. NQCI has also made a claim for reimbursement of approximately $690,000 in expenses related to the License Agreement which has been accrued at June 30, 2008 If we ever become obligated to pay all or a substantial portion of such amounts, doing so could have a material adverse effect on our liquidity and financial ability to continue with ongoing operations as currently planned.

The interim awards also state that 9,230,000 shares of our common stock would have to be issued to effectuate the Technology Transaction, if Closing such a transaction were to be approved by our stockholders. The issuance of such shares would result in NQCI owning approximately 38% of our total outstanding shares, diluting current stockholders and giving it the ability to substantially influence the outcome of matters submitted to stockholders.

**We expect to incur negative cash flows and net losses for the foreseeable future and may not be able to continue as a going concern.**

As a result of our expectation of negative cash flows and net losses for the foreseeable future, based on our current plans, we believe our existing cash reserves will not be sufficient to meet our operating expenses and capital requirements before we achieve profitability. Our ability to meet our cash obligations as they become due will depend on our ability to secure financing on acceptable terms. Unless we are able to raise capital sufficient to support our operations there will be substantial doubt of our ability to continue as a going concern.

**Approximately 42% of our stock is controlled by a single stockholder who has the ability to substantially influence the election of directors and the outcome of matters submitted to stockholders.**

As of April 9, 2008, CNL, a limited liability company whose managing member is our Executive Chairman, directly owned 6,232,596 shares, which represent approximately 42.4% of our 14,704,687 shares of outstanding common stock. As a result, CNL presently and is expected to continue to have the ability to determine the outcome of issues submitted to our stockholders. The interests of this stockholder may not always coincide with our interests or the interests of other stockholders, and it may act in a manner that advances its best interests and not necessarily those of other stockholders. One consequence to this substantial stockholder's interest is that it may be difficult for investors to remove management of the company. It could also deter unsolicited takeovers, including transactions in which stockholders might otherwise receive a premium for their shares over then current market prices.

**Sales of common stock by our existing stockholders, or the perception that such sales may occur, could depress our stock price.**

The market price of our common stock could decline as a result of sales by, or the perceived possibility of sales by, our existing stockholders, including stockholders who recently purchased their shares from CNL. Most of our outstanding shares were registered on a Form S-4 registration statement in connection with our October 2007 merger, and are eligible for public resale. Approximately half of our shares of common stock are currently held by our affiliates and may be sold pursuant to an effective registration statement or in accordance with the volume and other limitations of Rule 144 under the Securities Act of 1933, as amended, or pursuant to other exempt transactions. Future sales of common stock by significant stockholders, including those who acquired their shares in private placements or who are affiliates, or the perception that such sales may occur, could depress the price of our common stock.

**ITEM 2. Unregistered Sales of Equity Securities; Use of Proceeds from Registered Securities.**

In April 2008, we issued 20,000 shares of restricted common stock to Steven Solomon, our former Chief Executive Officer, as compensation for pre and post merger consulting services. We issued the shares in reliance upon the exemption from registration provided by Section 4(2) of the Securities Act of 1933, as amended, in a transaction not involving any public offering.

In April 2008, we re-issued 20,000 shares of restricted common stock to Rachel Glicksman pursuant to the request of CEOCast, Inc. and our Board approval. The initial authorization was for the issuance of the 20,000 shares directly to CEOCast, Inc. as compensation for investor relations services. We issued the shares in reliance upon the exemption from registration provided by Section 4(2), in a transaction not involving any public offering.

The above shares were registered for resale in a registration statement on Form S-3 filed under the Securities Act of 1933, which was declared effective on April 18, 2008.

**ITEM 6. Exhibits.**

| No. | Description of Exhibit |
|---|---|
| 31.1 | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certification of Chief Financial Officer 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.

| | | |
|---|---|---|
| Date: August 14, 2008 | By: | /s/ Robert Weinstein<br>Robert Weinstein<br>Chief Financial Officer<br>(Principal Financial Officer and Principal Accounting Officer) |