

NEPHROS INC  
Form DEF 14A  
December 02, 2010

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

**SCHEDULE 14A**

**Proxy Statement Pursuant to Section 14(a) of the  
Securities Exchange Act of 1934**

Filed by the Registrant  x  
Filed by a Party other than the Registrant  o  
Check the appropriate box:

o Preliminary Proxy Statement  
 o **Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))**  
 x Definitive Proxy Statement  
 o Definitive Additional Materials  
 o Soliciting Material Under Rule 14a-12

**NEPHROS, INC.**

(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

x No fee required.  
 o Fee computed on table below per Exchange Act Rules 14a-6(i)(1) and 0-11.  
(1) Title of each class of securities to which transaction applies:  
(2) Aggregate number of securities to which transaction applies:

(3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (Set forth the amount on which the filing fee is calculated and state how it was determined):

(4) Proposed maximum aggregate value of transaction:

(5) Total fee paid:

Fee paid previously with preliminary materials.

Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

(1) Amount Previously Paid:

(2) Form, Schedule or Registration Statement No.:

(3) Filing Party:

(4) Date Filed:

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**Nephros, Inc.**  
41 Grand Avenue  
River Edge, New Jersey 07661

**NOTICE OF ANNUAL MEETING OF STOCKHOLDERS  
To Be Held January 10, 2011**

**To The Stockholders of Nephros, Inc.:**

The Annual Meeting of Stockholders of Nephros, Inc., a Delaware corporation, will be held at the Crown Plaza Hotel, 401 South Van Brunt Street, Englewood, New Jersey, on Monday, January 10, 2011 at 10:00 a.m., Eastern Time, for the following purposes:

to elect one Director to serve for a three-year term expiring in 2013;  
to amend our Fourth Amended and Restated Certificate of Incorporation to increase the authorized shares of our capital stock from 95,000,000 to 905,000,000 shares and the authorized shares of our common stock from 90,000,000 to 900,000,000 shares;

to approve the amendment to our 2004 Stock Incentive Plan to increase the number of shares of common stock reserved for issuance thereunder from 2,696,976 shares to 39,814,340 shares;

to amend our Fourth Amended and Restated Certificate of Incorporation to effect a reverse stock split of our outstanding shares of common stock with a ratio of one share for every twenty shares of common stock and concurrently to decrease the authorized shares of our capital stock from 905,000,000 to 95,000,000 shares and the authorized shares of our common stock from 900,000,000 to 90,000,000 shares;

to ratify the selection of Rothstein Kass & Company, P.C., as our independent registered public accounting firm for the fiscal year ending December 31, 2010; and

to act upon such other matters as may properly come before the meeting or any adjournment thereof.

These matters are more fully described in the attached proxy statement. **As described in the attached proxy statement, the matters to be voted on are critical to the completion of our previously announced planned rights offering.**

The Board of Directors has fixed the close of business on November 29, 2010 as the record date for the determination of stockholders entitled to notice of and to vote at the meeting or any adjournment thereof. We cordially invite you to attend the meeting in person. However, to assure your representation at the meeting, please mark, sign, date and return the enclosed proxy as promptly as possible in the enclosed postage-prepaid envelope. If you attend the meeting you may vote in person, even if you returned a proxy.

Our proxy statement and proxy are enclosed, along with our Annual Report on Form 10-K for the fiscal year ended December 31, 2009.

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# **IMPORTANT YOUR PROXY IS ENCLOSED**

**Whether or not you plan to attend the meeting, please execute and promptly return the enclosed proxy in the enclosed envelope. No postage is required for mailing in the United States.**

By Order of the Board of Directors

Paul A. Mieyal  
*Acting Chief Executive Officer*

**IMPORTANT NOTICE REGARDING THE AVAILABILITY OF PROXY MATERIALS FOR THE ANNUAL MEETING OF STOCKHOLDERS TO BE HELD ON JANUARY 10, 2011:** Copies of this proxy statement and our Annual Report on Form 10-K for the 2009 fiscal year are available at: [www.nephros.com](http://www.nephros.com)

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**Nephros, Inc.  
41 Grand Avenue  
River Edge, New Jersey 07661**

**PROXY STATEMENT**

**ANNUAL MEETING OF STOCKHOLDERS  
JANUARY 10, 2011**

**INFORMATION CONCERNING SOLICITATION AND  
VOTING**

The enclosed proxy is solicited by the Board of Directors of Nephros, Inc., a Delaware corporation, for use at our Annual Meeting of Stockholders to be held at the Crown Plaza Hotel, 401 South Van Brunt Street, Englewood, New Jersey, on Monday, January 10, 2011 at 10:00 a.m., Eastern Time, and any adjournment thereof.

The mailing address of our principal executive offices is 41 Grand Avenue, River Edge, New Jersey 07661.

**Stockholders Entitled to Vote**

Only the holders of record of our common stock at the close of business on the record date, November 29, 2010, are entitled to notice of and to vote at the meeting. On the record date, 41,811,048 shares of our common stock were outstanding. Stockholders are entitled to one vote for each share of common stock held on the record date.

**Mailing of Proxy Statement and Form of Proxy**

This proxy statement and accompanying proxy card are being mailed to stockholders on or about December 2, 2010.

This proxy statement contains important information for you to consider when deciding how to vote on matters brought before the meeting. Please read it carefully. Our annual report on Form 10-K for fiscal 2009 is being mailed to stockholders together with this proxy statement.

## Voting

Our Board of Directors is asking for your proxy. Giving us your proxy means that you authorize us to vote your shares in the manner you direct in the proxy at our Annual Meeting of Stockholders to be held at the Crown Plaza Hotel, 401 South Van Brunt Street, Englewood, New Jersey, on Monday, January 10, 2011 at 10:00 a.m., Eastern Time, and any adjournment thereof.

You may vote for or withhold your vote from our director candidate. The election of the nominee for director requires a plurality of votes cast. Accordingly, abstentions and broker non-votes (that is, proxies from brokers or nominees indicating that such persons have not received instructions from the beneficial owner or other persons entitled to vote shares on a particular matter with respect to which brokers or nominees do not have discretionary power) will not affect the outcome of the election.

You may vote for or against or abstain from voting for the proposals to amend our 2004 Stock Incentive Plan and to ratify the appointment by the Audit Committee of our independent registered public accounting

firm for the fiscal year ending December 31, 2010. The affirmative vote of a majority of the shares of common stock represented and voted at the annual meeting is required for approval of these matters. On these matters, abstentions will have the same effect as a negative vote. However, because broker non-votes will not be treated as shares that are present and entitled to vote with respect to a specific proposal, broker non-votes will have no effect on the outcome of these matters.

You may vote for, or against or abstain from voting for the proposals to amend our Fourth Amended and Restated Certificate of Incorporation (Proposal No. 2) to increase our authorized shares and to effect the 1-for-20 reverse stock split and concurrently to decrease our authorized shares (Proposal No. 4). The affirmative vote of a majority of the outstanding shares of our common stock is required for approval of these matters. On these matters, abstentions and broker non-votes will have the same effect as a negative vote.

No broker may vote on the proposal to elect a director or on any charter amendment proposals without your specific instructions.

When the enclosed proxy is properly executed and returned (and not subsequently properly revoked, as described below), the shares it represents will be voted in accordance with the directions indicated thereon, or, if no direction is indicated thereon, it will be voted:

- (1) FOR the election of the one Class III Director nominee identified herein;  
FOR the approval of the amendment to our Fourth Amended and Restated Certificate of Incorporation to increase
- (2) the authorized shares of our capital stock from 95,000,000 to 905,000,000 shares and the authorized shares of our common stock from 90,000,000 to 900,000,000 shares;
- (3) FOR the approval of the amendment to our 2004 Stock Incentive Plan to increase the number of shares of common stock reserved for issuance thereunder from 2,696,976 shares to 39,814,340 shares;
- (4) FOR the approval of the amendment to our Fourth Amended and Restated Certificate of Incorporation to effect a reverse stock split of our outstanding shares of common stock with a ratio of one share for every twenty shares of common stock and concurrently to decrease the authorized shares of our capital stock from 905,000,000 to 95,000,000 shares and the authorized shares of our common stock from 900,000,000 to 90,000,000 shares;
- (5) FOR the ratification of the selection of Rothstein Kass & Company, P.C., as our independent registered public accounting firm for the fiscal year ending December 31, 2010; and
- (6) in the discretion of the proxies, with respect to any other matters properly brought before the stockholders at the meeting.

## Quorum

A majority of the voting power of the outstanding shares entitled to vote at the meeting shall constitute a quorum, whether present in person or by proxy. In accordance with Delaware law, broker non-votes, abstentions and votes withheld from any director will be counted for purposes of determining the presence or absence of a quorum for the transaction of business.

## Record and Beneficial Shareholdings

You may receive more than one proxy or voting card depending on how you hold your shares. Shares registered in your name are covered by one card. If you hold shares through someone else, such as a stockbroker, you may receive material from them asking how you want to vote those shares.

## **Solicitation of Proxies**

We will bear the cost of soliciting proxies. In addition to solicitation of proxies by mail, our employees, without extra remuneration, may solicit proxies personally or by telephone. We will reimburse brokerage firms and other custodians, nominees and fiduciaries for their reasonable out-of-pocket expenses for forwarding proxy materials to beneficial owners and seeking instruction with respect thereto. In addition, we have hired Morrow & Co., LLC to assist us in soliciting proxies in connection with the annual meeting. We will pay Morrow's fees, which we expect to be approximately \$3,500, plus all expenses for such services.

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## **Revoking a Proxy**

You may revoke your proxy by sending in a new proxy card with a later date or by sending written notice of revocation to our corporate secretary (Gerald J. Kochanski) at our principal executive offices. If you attend the meeting, you may revoke in writing previously submitted proxies and vote in person.

## **Attending in Person**

Only stockholders, their proxy holders and our guests may attend the meeting. If you want to vote in person at the annual meeting, and you hold your shares through a securities broker (that is, in street name), then you must obtain a proxy from your broker and bring that proxy to the meeting.

## PROPOSAL NO. 1 ELECTION OF DIRECTOR

At the annual meeting, one director will be elected to serve a three-year term that will expire at the close of our annual meeting to be held during 2013. The shares represented by the enclosed proxy will be voted to elect as a director the nominee named below, unless a vote is withheld for such nominee. If the nominee cannot or will not serve as a director (which events are not anticipated), then the shares represented by the enclosed proxy may be voted for another person as determined by the holder of the proxies.

### Director Independence

Although our common stock is no longer listed on NYSE Alternext US LLC (formerly, the American Stock Exchange or AMEX ) our Board of Directors complies with the AMEX listing standards for director independence and reviews all commercial and other relationships of each director in making its determination as to the independence of our directors. After such review, the Board has determined that each of Mr. Amron, Mr. Centella and Mr. Scibetta qualifies as independent under the requirements of the AMEX listing standards. Mr. Mieyal is not independent due to his position as our Acting Chief Executive Officer.

### Director Classes

Our board of directors is divided into three classes, each class as nearly equal in number as practicable. Each year, one class is elected to serve for three years.

### Board Nominee

The Board of Directors has nominated Lawrence J. Centella for re-election as a Class III director. Mr. Centella would serve a three-year term expiring at the close of our annual meeting to be held during 2013. Biographical information regarding Mr. Centella is set forth below:

Name	Age (as of 10/31/10)	Director Since	Business Experience For Last Five Years
Lawrence J. Centella	69	2001	Lawrence J. Centella has served as a director of our company since January 2001. Mr. Centella serves as president of Renal Patient Services, LLC, a company that owns and operates dialysis centers, and has served in such capacity since June 1998. From 1997 to 1998, Mr. Centella served as executive vice president and chief operating officer of Gambro Healthcare, Inc., an integrated dialysis company that manufactured dialysis equipment, supplied dialysis equipment and operated dialysis clinics. From 1993 to 1997, Mr. Centella served as president and chief executive officer of Gambro Healthcare Patient Services, Inc. (formerly REN Corporation). Prior to that, Mr. Centella served as president of COBE Renal Care, Inc., Gambro Hospital, Inc., LADA International, Inc. and Gambro, Inc. Mr. Centella is also the founder of LADA International,

Inc. Mr. Centella received a B.S. from DePaul University. Among other experience, qualifications, attributes and skills, Mr. Centella's extensive experience in managing companies engaged in the business of dialysis centers and equipment, led to the conclusion of our Board that he should serve as a director of our company in light of our business and structure.

## **Vote Required**

No minimum vote is required for the nominee to be elected. If any other nominee is put forward at the meeting, the nominee receiving the highest number of affirmative votes of the shares present or represented and entitled to be voted at the meeting shall be elected as a director. Stockholders do not have cumulative voting rights. Your vote may be cast *for* or *withheld* from the nominee.

**Our Board of Directors has unanimously approved and recommends that stockholders vote FOR the election of Mr. Centella as our Class III director (Item 1 of the enclosed proxy card).**

## **PROPOSAL NO. 2**

# **AMENDMENT OF OUR CERTIFICATE OF INCORPORATION TO INCREASE OUR AUTHORIZED SHARES**

Our Board of Directors has unanimously determined that it is advisable to amend Article IV, Section 2 of our Certificate of Incorporation to increase the number of authorized shares of our capital stock from 95,000,000 shares to 905,000,000 shares and to increase the number of authorized shares of common stock from 90,000,000 shares to 900,000,000 shares.

Currently, our Certificate of Incorporation authorizes an aggregate of 95,000,000 shares of capital stock. These authorized shares consist of 90,000,000 shares of common stock and 5,000,000 shares of preferred stock. The preferred stock may be issued in such classes and series with such rights and privileges as our Board of Directors may determine. No shares of preferred stock are issued and outstanding. As of October 31, 2010, we had 41,811,048 shares of common stock issued and outstanding and 11,074,463 shares reserved for future issuance under outstanding warrants and options. This leaves only 37,114,489 shares of common stock available for future issuance for purposes other than awards under our 2004 Stock Incentive Plan.

As previously announced, we intend to undertake a rights offering to all of our stockholders to raise \$3.5 million in new capital. Our stockholders would receive in the rights offering, at no cost, rights to purchase units, each consisting of one share of our common stock and five-year warrants to purchase 0.924532845 shares of our common stock. Each stockholder will receive rights to purchase 4.185496618 units for each share of our common stock owned on the record date for the rights offering. The subscription price per unit will be \$0.02. Lambda Investors LLC ( Lambda Investors ), our largest stockholder, has agreed to surrender for cancellation a portion of its existing warrants containing anti-dilution provisions that will be triggered by the rights offering. The number of shares underlying such cancelled warrants would equal the total number of shares underlying the warrants to be issued in the rights offering. The term of the remaining Lambda Investors warrants will then be extended so that such warrants will expire at the same time as the warrants issued in the rights offering. We propose to undertake the rights offering because without an infusion of new capital, we do not believe our company can continue to operate beyond February 2011.

Lambda Investors required that we undertake the rights offering as a condition to making the loan it extended to us on October 1, 2010 in the amount of \$500,000. In its loan proposal, Lambda Investors specified a rights offering of 175,000,000 units consisting of shares and warrants to purchase shares of our common stock, and that it be made at a subscription price of \$0.02 per unit to encourage our other stockholders to participate. At the time of the loan proposal, the market price for our common stock ranged between \$0.16 and \$0.20, as reported on the OTC Bulletin Board. The loan and the rights offering, as proposed by Lambda Investors, including the \$0.02 per unit subscription price, were approved by a special committee of our independent directors (none of whom are affiliated with Lambda Investors) after consideration of the financing alternatives available to us. In an effort to minimize the dilutive effect of the rights offering, Lambda Investors also proposed that it would surrender for cancellation that portion of its existing warrants containing anti-dilution provisions that will be triggered by the rights offering discussed above. The special committee considered, among other things, that (i) we are not currently in a position to attract an outside investor or investors with a stock offering at a more favorable discount to the current trading price of our stock, and (ii) even if we were able to make such an offering, without any inducement for Lambda Investors to surrender for cancellation a portion of its existing warrants as it has agreed to do in the rights offering, the dilution suffered by

current investors would have been approximately equal to or greater than the dilution that participating investors will be subject to in the rights offering. The \$0.02 per unit subscription price was not based on any discount to the market price of our common stock. The subscription price is not necessarily related to our book value, net worth or any other established criteria of value and may or may not be considered the fair value of our common stock included in the units being offered in the rights offering. We did not consult with any financial or other advisor in determining the subscription price. On November 26, 2010, the closing sale price of our common stock on the OTC Bulletin Board was \$0.16 per share.

To effect the rights offering, however, we must increase the number of authorized shares of our common stock. If the proposed rights offering is fully subscribed, we will be issuing (i) 175,000,000 shares of our

common stock and (ii) warrants to purchase an additional 161,793,248 shares of our common stock. In addition, upon completion of the rights offering, we will have outstanding (i) options to purchase 185,660 shares of our common stock under our 2000 Equity Incentive Plan and 707,622 shares of our common stock under our 2004 Stock Incentive Plan and (ii) previously issued warrants to purchase 175,987,497 shares of our common stock (assuming the rights offering is fully subscribed, after giving effect to the full-ratchet anti-dilution adjustment of certain of these warrants and the subsequent cancellation of warrants to purchase 161,793,248 shares of our common stock, both of which will occur upon completion of the rights offering). We do not currently have a sufficient number of authorized shares of common stock to (i) issue shares of common stock in the rights offering, (ii) reserve shares of common stock to issue upon exercise of the warrants to be issued in the rights offering, (iii) accommodate the increase (due to the full-ratchet anti-dilution adjustment) in the number of shares of common stock issuable upon exercise of certain of our warrants that were issued prior to and will remain outstanding following the completion of the rights offering, and (iv) leave sufficient number of shares reserved under our 2000 Equity Incentive Plan and 2004 Stock Incentive Plan to cover shares of common stock issuable upon exercise of our outstanding options under such plans and to provide for future grants under our 2004 Stock Incentive Plan. We will also have no authorized shares of common stock available for future issuances if our Board of Directors determines that such issuances are in our and our stockholders' best interests. If the amendment to our Fourth Amended and Restated Certificate of Incorporation contemplated by this Proposal No. 2 is not approved by the stockholders, we will not be able to effect the rights offering and expect that we would be required to begin winding down our operations.

The rights offering will not begin until after the annual meeting. We expect that the total purchase price of the units offered in the rights offering to be approximately \$3.5 million, assuming full participation. We have filed a registration statement relating to the rights offering with the Securities and Exchange Commission, or SEC, but the registration statement has not yet become effective. These securities may not be sold, nor may offers to buy be accepted, prior to the time the registration statement becomes effective. After the registration statement becomes effective, a written prospectus relating to the rights offering meeting the requirements of Section 10 of the Securities Act of 1933, as amended, may be obtained from us by contacting Gerald Kochanski, Chief Financial Officer, Nephros, Inc., 41 Grand Avenue, River Edge, New Jersey 07661. This proxy statement shall not constitute an offer to sell or the solicitation of an offer to buy, nor shall there be any sale of these securities in any state in which such offer, solicitation or sale would be unlawful prior to their registration or qualification under the securities laws of any such state.

In addition, if the amendment to our Fourth Amended and Restated Certificate of Incorporation contemplated by this Proposal No. 2 is not approved by the stockholders, we will not effect either Proposal No. 3, the increase in the number of shares reserved under our 2004 Stock Incentive Plan, or Proposal No. 4, the reverse stock split and concurrent amendment to our Fourth Amended and Restated Certificate of Incorporation, as those actions will be necessary only in the event the rights offering is completed.

We also believe that an increase in the number of authorized shares of our common stock is prudent in order to assure that a sufficient number of shares of common stock is available for issuance in the future, without the delay or expense of holding a special stockholder meeting to further amend our certificate of incorporation, if our Board of Directors deems it to be in our and our stockholders' best interests.

Our Board of Directors has determined that an additional 810,000,000 shares of common stock would be a sufficient amount to effect the rights offering and, thereafter, to provide a reasonable number of additional shares available for issuance should the Board find it appropriate. Immediately following this increase, if approved, we will have 41,811,048 shares of common stock issued and outstanding and 11,074,463 shares reserved for future issuance under existing warrants and options. As stated above, assuming all units offered in the proposed rights offering are subscribed for, we would issue approximately 175,000,000 shares of common stock and warrants to purchase 161,793,248 shares of common stock in the offering.

As of October 31, 2010, Lambda Investors beneficially owned approximately 43.9% of the outstanding shares of our common stock (which includes warrants to purchase an aggregate of 7,190,811 shares of our common stock). Lambda Investors will have the right to subscribe for and purchase units in the rights offering. Lambda Investors has agreed to exercise all of its basic subscription privilege in full, subject to certain conditions, including the condition that stockholders not affiliated with Lambda Investors subscribe for at least

50% of the units offered in the rights offering. If this and other conditions are met and Lambda Investors exercises its basic subscription privilege in full, and all other units available in the rights offering are fully subscribed for by stockholders not affiliated with Lambda Investors, the beneficial ownership percentage of Lambda Investors following completion of the rights offering will increase to approximately 67.2% of our common stock (after giving effect to the anti-dilution provisions contained in its existing warrants and its surrender of a portion of these warrants upon completion of the rights offering). If this occurs, it will enhance the ability Lambda Investors already has to exercise substantial control over matters requiring stockholder approval.

After giving effect to the proposed rights offering, assuming all units offered are subscribed for, and after giving effect to the full-ratchet anti-dilution adjustment to certain existing warrants and the subsequent cancellation of a portion of these warrants, we would have 216,811,048 shares of common stock issued and outstanding, 337,780,745 shares reserved for issuance pursuant to outstanding warrants, 185,660 shares reserved for issuance pursuant to outstanding options under our 2000 Equity Incentive Plan, 707,622 shares reserved for issuance pursuant to outstanding options under our 2004 Stock Incentive Plan and 1,650,708 shares reserved for future grants under our 2004 Stock Incentive Plan. This would represent a total of 557,135,783 shares of common stock and would leave us 342,864,217 shares for future issuance. (Please see Proposal No. 4 regarding the effect of the reverse stock split contemplated by such proposal on the number of shares of common stock that would be outstanding after completion of the rights offering.)

The remaining authorized but unissued and unreserved shares of common stock will be available for issuance from time to time as our Board of Directors may deem necessary or advisable for various purposes, including, but not limited to, raising capital, establishing strategic relationships with other companies, acquiring businesses or assets and declaring stock dividends or effecting stock splits. Our Board will be able to authorize the issuance of shares for these purposes without the necessity, and related costs and delays, of either calling a special stockholders meeting or waiting for the next annual meeting of stockholders in order to increase the authorized shares of capital stock. Such issuances might require stockholder approval under other applicable rules, in which case we would present the matter to our stockholders for their approval. Assuming the proposed rights offering is successful and we raise \$3.5 million in gross proceeds from the rights offering, we expect we would need additional capital in the first quarter of 2012 to continue our operations. Given that anticipated need for additional capital, we may issue a portion of the newly authorized shares of common stock at such time as the Board of Directors, in its sole discretion, deems it advisable.

Other than the proposed rights offering, we currently have no commitments, arrangements, understandings or agreements, whether oral or written, regarding any issuance of any portion of the additional authorized shares of common stock.

The relative rights and limitations of the shares of common stock will remain unchanged if the amendment to our Fourth Amended and Restated Certificate of Incorporation contemplated by this Proposal No. 2 is approved. Our stockholders will not realize any dilution in their percentage of ownership of our company or their voting rights as a result of the increase in our authorized shares. However, the issuance of shares in the proposed rights offering will dilute a stockholder's percentage of ownership, and to a significant degree to the extent a stockholder does not participate in the rights offering. In connection with the rights offering, full-ratchet anti-dilution protection provisions in certain previously issued warrants to purchase 7,519,246 shares of our common stock will cause those warrants to adjust and become exercisable for an aggregate of 337,108,164 shares (although warrants to purchase 161,793,248 of these shares will be cancelled upon completion of the rights offering, assuming it is fully subscribed). In addition, issuances of significant numbers of additional shares of common stock in the future may dilute stockholders percentage ownership of our company and if such shares are issued at prices below what current stockholders paid for their shares, may dilute the value of current stockholders' shares.

The proposed increase in our authorized common stock, under certain circumstances, could have an anti-takeover effect, although this is not the intent of our Board of Directors. For example, it could be possible for our Board to delay or impede a takeover or change in control of our company by causing additional shares to be issued to holders



who might side with the Board in opposing a takeover bid that the Board determines is not in our or our stockholders best interests. The increased authorized capital therefore could have the effect of discouraging unsolicited takeover attempts. By potentially discouraging initiation of any such unsolicited

takeover attempts, the increased common stock could limit the opportunity for our stockholders to dispose of their shares at the higher price generally available in takeover attempts or that may be available under a merger proposal. Further, the increased authorized capital could have the effect of permitting our management, including our Board, to retain its position, and place it in a better position to resist changes that stockholders may wish to make if they are dissatisfied with the conduct of our business. Our Board of Directors is not aware of any attempt, or contemplated attempt, to acquire control of our company, and this proposal is not being presented with the intent that it be used as a type of anti-takeover device.

If Proposal No. 2 is approved, then Article IV, Section 2, of our Fourth Amended and Restated Certificate of Incorporation will be amended in its entirety to read as follows:

Section 2 Capital Stock . The total authorized capital stock of the Corporation shall be: 905,000,000 shares, consisting of:

- (i) 900,000,000 shares of Common Stock, \$.001 par value per share (the Common Stock );
- (ii) 5,000,000 shares of preferred stock, \$.001 par value per share (collectively, the Undesignated Preferred Stock ). Subject to any limitations set forth elsewhere in this Certificate of Incorporation, the shares of Undesignated Preferred Stock may be issued from time to time in one or more series. Subject to any limitations set forth elsewhere in this Certificate of Incorporation, the Board of Directors is hereby authorized, by adopting appropriate resolutions and causing one or more certificates of amendment to be signed, verified and delivered in accordance with the DGCL, to establish from time to time the number of shares to be included in such series, and to fix the powers, preferences and rights of, and the qualifications, limitations and restrictions granted to and imposed upon such Undesignated Preferred Stock. Such powers, preferences and rights of, and the qualifications, limitations and restrictions granted to and imposed upon such Undesignated Preferred Stock may include, but are not limited to, the fixing or alteration of the dividend rights, dividend rate, conversion rights, exchange rights, voting rights, rights and terms of redemption (including sinking fund provisions), the redemption price or prices, and the liquidation preferences of any wholly unissued series of shares of Undesignated Preferred Stock, or any of them. In accordance with the authority hereby granted, the Board may increase or decrease the number of shares of any series of preferred stock, whether or not such preferred stock then constitutes Undesignated Preferred Stock, subsequent to the issuance of shares of that series; provided that any such increase shall be no greater than the total number of authorized shares of Undesignated Preferred Stock at such time, and no such decrease shall result in the number of authorized shares of such series being fewer than the number then outstanding. In case the number of shares of any series of preferred stock, other than Undesignated Preferred Stock, shall be so decreased, the shares constituting such decrease shall become Additional Undesignated Preferred Stock. Any shares of a series of preferred stock, which is designated pursuant to this clause (ii), that were issued but, thereafter, are no longer outstanding shall not resume the status of authorized and unissued shares of such series, but shall instead become authorized and unissued shares of Additional Undesignated Preferred Stock. Except as may otherwise be required by law or this Certificate of Incorporation, the terms of any series of Undesignated Preferred Stock may be amended without the consent of the holders of any other series of the Corporation s preferred stock, or Common Stock.

If the foregoing amendment to our Fourth Amended and Restated Certificate of Incorporation is approved by the stockholders, it will become effective once it is filed with the Secretary of State of Delaware. We intend to file the amendment immediately prior to the close of our planned rights offering.

## Vote Required

Approval of the amendment to our Fourth Amended and Restated Certificate of Incorporation requires the affirmative vote of the holders of at least a majority of the outstanding shares of our common stock. Abstentions and broker non-votes will have the same effect as votes against Proposal No. 2.

**Our Board of Directors unanimously recommends that you vote FOR approval of the amendment to our Fourth Amended and Restated Certificate of Incorporation to increase our authorized shares (Item 2 of the enclosed proxy card).**

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## PROPOSAL NO. 3

# APPROVAL OF THE AMENDMENT TO THE 2004 STOCK INCENTIVE PLAN

In July 2004, our Board of Directors adopted and our stockholders approved the Nephros, Inc. 2004 Stock Incentive Plan (the "2004 Plan"). Our stockholders approved amendments to increase the number of shares authorized for issuance under the 2004 Plan to 800,000 shares, in June 2005; to 1,300,000 shares, in May 2007; and to 2,696,976 shares, in June 2008. As of October 31, 2010, options to purchase 1,046,268 shares had been issued under the 2004 Plan, of which options for 338,646 shares had been exercised and options for 707,622 shares were outstanding. The outstanding options expire on various dates between November 11, 2014 and January 8, 2020, and vest upon a combination of immediate vesting or straight-line vesting of two or four years. At October 31, 2010, 1,650,708 shares remained available for future grants under the 2004 Plan.

We also have outstanding options to purchase an aggregate of 185,660 shares that were issued under our 2000 Equity Incentive Plan. The 2000 Equity Incentive Plan was retired and no additional shares are available for issuance and no additional options may be granted under the 2000 Equity Incentive Plan.

The Board has approved an increase in the number of shares authorized for issuance under the 2004 Plan by 37,117,364 shares. If the amendment to the 2004 Plan contemplated by this Proposal No. 3 is approved at the meeting, there will be a total of 39,814,340 shares of common stock authorized for issuance under the 2004 Plan with a total of 38,768,072 shares available for issuance in the form of new grants, and the total shares reserved for the 2000 Equity Incentive Plan and the 2004 Stock Incentive Plan would total 40,000,000 shares.

The reasons we are proposing the increase are (i) to maintain an equity compensation pool representing a competitive percentage (6.7%) of the company's equity structure and (ii) to accommodate the proposed one-for-twenty reverse stock split contemplated by Proposal No. 4. If the reverse stock split is approved, and Proposal No. 3 is not approved, the number of shares reserved under the 2004 Plan would be reduced to 134,849, and the number of shares available for future grant would be reduced to only 82,535 shares, which we believe would not be sufficient to incentivize our employees and directors and to attract promising new employees. If the reverse stock split is not approved, we will not amend the 2004 Plan even if the proposed increase in the shares available for issuance under the 2004 Plan is approved.

If the increase the number of shares available under the 2004 Plan contemplated by this Proposal No. 3 is approved and the reverse stock split contemplated by Proposal No. 4 also is approved, the shares authorized for issuance under the 2004 Plan after the reverse stock split would be 1,990,717 and the number of shares available for future grants would be 1,938,404. The total shares reserved for issuance under the 2000 Equity Incentive Plan and the 2004 Plan, after giving effect to the rights offering and the reverse stock split, would represent 6.7% of our company on a fully diluted basis, compared to 5.5% represented by the current number of shares authorized under the two plans.

The 2004 Plan, currently administered by our Compensation Committee, authorizes our Board of Directors or Compensation Committee to grant stock options and other equity awards to eligible employees, directors and consultants and is structured to allow our Board or Compensation Committee broad discretion in creating equity incentives. We believe that equity awards made under the 2004 Plan are an important incentive for our employees. Equity awards, including option grants, are a significant part of our ability to attract, retain and motivate people whose

skills and performance are critical to our success. Our goal is to link employee compensation to corporate performance because we believe that this increases employee motivation to improve stockholder value. We have, therefore, consistently included equity incentives as a significant component of compensation for our employees. As stated above, effecting the proposed reverse stock split without also increasing the shares available under the 2004 Plan would leave only 82,535 shares of common stock available for issuance under the 2004 Plan, an amount of shares that our Board of Directors believes would be insufficient to accomplish the purposes of the 2004 Plan as described above.

The full text of the 2004 Plan, as proposed to be amended is included as Appendix A to this Proxy Statement. A summary description of the 2004 Plan is found under Other Information 2004 Stock Incentive Plan.

For the reasons stated above, the Board believes it is in the company's best interests to approve the amendment to increase the number of shares reserved for issuance under the 2004 Plan.

## **Vote Required**

Approval of the amendment to the 2004 Plan requires the affirmative vote of the holders of at least a majority of the shares of our common stock present or represented at the meeting. Abstentions will have the same effect as votes against Proposal No. 5. However, because broker non-votes will not be treated as shares that are present and entitled to vote with respect to a specific proposal, broker non-votes will have no effect on the outcome of this matter.

**The Board of Directors unanimously recommends that you vote For approval of the amendment to the 2004 Stock Incentive Plan (Item 3 of the enclosed proxy card).**

# PROPOSAL NO. 4

## AMENDMENT OF OUR CERTIFICATE OF INCORPORATION TO EFFECT A REVERSE STOCK SPLIT AND DECREASE OUR AUTHORIZED SHARES

Our Board of Directors has unanimously determined that it is advisable and in the best interests of our company and our stockholders to effect a reverse stock split of our outstanding shares of common stock. The Board has proposed that the reverse stock split will be effected at a ratio of one share of common stock for every twenty shares of common stock. Pursuant to the reverse stock split the number of outstanding shares of common stock would be reduced proportionately by the reverse split ratio. As part of the reverse stock split, our Board of Directors also has unanimously determined that it is advisable and in the best interests of our company and our stockholders to amend Article IV, Section 2 of our Fourth Amended and Restated Certificate of Incorporation, as amended, in order to effect a one-for-twenty reverse stock split of our outstanding shares of common stock and concurrently to decrease the authorized shares of our capital stock from 905,000,000 to 95,000,000 shares and the authorized shares of common stock from 900,000,000 to 90,000,000 shares. These authorized amounts assume that the amendment set forth in Proposal No. 2 has been approved and effected.

Pursuant to the reverse stock split, every 20 shares of common stock registered in the name of a stockholder at the effective time of the reverse stock split will be converted into one share of common stock. However, as permitted under Delaware law, shares of common stock that would be converted into less than one share in the reverse stock split will instead be converted into the right to receive a cash payment as described below. Pursuant to the reverse stock split, the number of outstanding shares of common stock would be reduced proportionately by the reverse split ratio.

Since our Board of Directors plans to effect the amendment to increase our authorized capital stock described in Proposal No. 2 prior to the closing of the rights offering, and will only effect this amendment following the rights offering, we have assumed the approval and effectuation of Proposal No. 2 in this discussion of Proposal No. 4, except where otherwise noted. This Proposal No. 4 would in effect return the authorized numbers of shares of our capital stock and common stock to the numbers of shares that were authorized under our Fourth Amended and Restated Certificate of Incorporation prior to the approval and effectuation of Proposal No. 2.

### Reasons for the Reverse Stock Split and Decrease in Authorized Shares

The Board believes that the reverse stock split and decrease in our authorized shares are in the best interests of the company and our stockholders for the following reasons:

*Increased Share Price.* A reverse stock split may increase the trading price of shares of our common stock, making them more attractive investments generally and to institutional investors in particular.

*Reduced Shareholder Transaction Costs.* Because investors typically pay commissions based on the number of shares traded when they buy or sell shares of our common stock, such investors would pay lower commissions for trading a given dollar amount of our common stock if the reverse stock split is completed.

*Increased Earnings Per Share.* To the extent that we have positive net income in future periods, a decrease in the number of shares of our common stock issued and outstanding would have the result of increasing our nominal earnings per share, which could help our visibility in the marketplace and increase the level of confidence in our common stock.

*Relative Increase in Number of Shares Authorized for Issuance.* Currently, less than 55% of our authorized shares of common stock are available for issuance. If our stockholders approve and the Board implements the reverse stock split and decrease in authorized shares contemplated by this Proposal No. 4, the relative reduction in the number of our issued and outstanding shares of common stock will exceed the reduction in the number of shares of our common stock that are authorized for issuance. Accordingly, relatively more shares of our common stock will be available for future issuance for a variety of corporate purposes, including capital-raising and potential acquisitions. The Board believes this will provide the Company with additional strategic and operational flexibility in the future.