

NovaBay Pharmaceuticals, Inc.
Form 10-Q
July 31, 2014
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2014

OR

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

For the transition period from _____ to _____

Commission file number 001-33678

NOVABAY PHARMACEUTICALS, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of incorporation or
organization)

68-0454536
(I.R.S. Employer Identification No.)

5980 Horton Street, Suite 550, Emeryville CA 94608

(Address of principal executive offices) (Zip Code)

Registrant's Telephone Number, Including Area Code: (510) 899-8800

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company)

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

As of July 28, 2014, there were 50,779,057 shares of the registrant's common stock outstanding.

NOVABAY PHARMACEUTICALS, INC.

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Unless the context requires otherwise, all references in this report to “we,” “our,” “us,” the “Company” and “NovaBay” refer to NovaBay Pharmaceuticals, Inc. and its subsidiaries.

NovaBay[®], NovaBay Pharma[®], AgaNase[®], Aganocide[®], NeutroPhase[®], AgaDerm[®], and Going Beyond Antibiotics[™] are trademarks of NovaBay Pharmaceuticals, Inc. All other trademarks and trade names are the property of their respective owners.

PART I**FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****NOVABAY PHARMACEUTICALS, INC.****(a development stage company)****CONSOLIDATED BALANCE SHEETS**

	June 30, 2014	December 31, 2013
	(unaudited)	(Note 2)
<u>(in thousands, except per share data)</u>		
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 7,757	\$ 10,500
Short-term investments	3,808	2,553
Accounts receivable	440	784
Inventory	218	231
Prepaid expenses and other current assets	656	723
Total current assets	12,879	14,791
Property and equipment, net	488	718
Other assets	146	141
TOTAL ASSETS	\$ 13,513	\$ 15,650
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Current liabilities:		
Accounts payable	\$ 520	\$ 1,674
Accrued liabilities	1,301	1,616
Deferred revenue	196	337
Total current liabilities	2,017	3,627
Deferred revenues - non-current	1,601	1,534
Deferred rent	155	136
Warrant liability	520	1,837
Total liabilities	4,293	7,134
Stockholders' equity:		
Preferred stock, \$0.01 par value; 5,000 shares authorized; none outstanding at June 30, 2014 and December 31, 2013	—	—
Common stock, \$0.01 par value; 120,000 shares authorized at June 30, 2014 and 65,000 shares authorized at December 31, 2013; 50,779 and 44,624 issued and outstanding at June	508	446

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30, 2014 and December 31, 2013, respectively

Additional paid-in capital	71,586	64,438
Accumulated other comprehensive loss	(13)	(15)
Accumulated deficit during development stage	(62,861)	(56,353)
Total stockholders' equity	9,220	8,516
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 13,513	\$ 15,650

The accompanying notes are an integral part of these consolidated financial statements.

NOVABAY PHARMACEUTICALS, INC.**(a development stage company)****CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS****(unaudited)**

	Three Months Ended June 30,		Six Months Ended June 30,		Cumulative Period from July 1, 2002 (inception) to June 30, 2014
<u>(in thousands, except per share data)</u>	2014	2013	2014	2013	
Sales:					
Product revenue	\$21	\$17	\$209	\$80	\$ 446
Cost of goods sold	18	16	148	38	318
Gross profit	3	1	61	42	128
Other revenue:					
License, collaboration and distribution revenue	38	790	76	1,704	60,575
Other revenues	64	41	126	84	439
Total other revenue	102	831	202	1,788	61,014
Operating expenses:					
Research and development	2,238	2,937	4,766	5,911	77,373
General and administrative	1,653	2,045	3,361	3,556	49,328
Total operating expenses	3,891	4,982	8,127	9,467	126,701
Operating loss	(3,786)	(4,150)	(7,864)	(7,637)	(65,559)
Non-cash gain (loss) on changes in fair value of warrants	797	104	1,317	(416)	1,469
Other income (expense), net	57	5	50	5	1,316
Loss before provision for income taxes	(2,932)	(4,041)	(6,497)	(8,048)	(62,774)
Provision for income taxes	(10)	(7)	(10)	(9)	(87)
Net loss	(2,942)	(4,048)	(6,507)	(8,057)	(62,861)
Change in unrealized gains (losses) on available-for-sale securities	—	(8)	2	(6)	(13)
Comprehensive loss	\$(2,942)	\$(4,056)	\$(6,505)	\$(8,063)	\$(62,874)
Net loss per share:					
Basic and diluted	\$(0.06)	\$(0.11)	\$(0.14)	\$(0.22)	
Shares used in per share calculations:					

Basic and diluted	50,767	37,266	48,067	37,013
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The accompanying notes are an integral part of these consolidated financial statements.

NOVABAY PHARMACEUTICALS, INC.**(a development stage company)****CONSOLIDATED STATEMENTS OF CASH FLOWS****(unaudited)**

	Six Months Ended June 30,		Cumulative Period from July 1, 2002 (inception) to
	2014	2013	June 30, 2014
(in thousands)			
Cash flows from operating activities:			
Net loss	\$(6,507)	\$(8,057)	\$(62,861)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	141	161	2,725
Accretion of discount on short-term investments	—	—	(252)
Net realized loss on sales of short-term investments	19	14	156
Loss (gain) on disposal of property and equipment	(53)	—	260
Stock-based compensation expense for options and stock issued to employees and directors	442	511	7,404
Compensation expense for warrants issued for services	—	166	366
Stock-based compensation expense for options, warrants and stock issued to non-employees	82	69	1,421
Non-cash loss (gain) on changes in fair value of warrants	(1,317)	416	(1,469)
Taxes paid by LLC	—	—	1
Changes in operating assets and liabilities:			
(Increase) decrease in accounts receivable	403	831	(381)
(Increase) decrease in inventory	12	(25)	(219)
(Increase) decrease in prepaid expenses and other assets	55	11	(611)
Increase (decrease) in accounts payable and accrued liabilities	(1,372)	400	2,260
Increase (decrease) in deferred revenue	(74)	(385)	2,146
Net cash used in operating activities	(8,169)	(5,888)	(49,054)
Cash flows from investing activities:			
Purchases of property and equipment	(21)	(31)	(3,523)
Proceeds from disposal of property and equipment	102	—	154
Purchases of short-term investments	(4,012)	(3,899)	(121,760)
Proceeds from maturities and sales of short-term investments	2,750	3,200	117,977
Cash acquired in purchase of LLC	—	—	516
Net cash used in investing activities	(1,181)	(730)	(6,636)

Cash flows from financing activities:

Proceeds from preferred stock issuances, net	—	—	11,160
Proceeds from common stock issuances	74	417	8,967
Proceeds from exercise of options and warrants	6	60	5,012
Proceeds from initial public offering, net of costs	—	—	17,077
Proceeds from shelf offering, net of costs	6,527	—	20,110
Proceeds from stock subscription receivable	—	—	873
Proceeds from issuance of notes	—	—	405
Principal payments on capital lease	—	—	(157)
Proceeds from short-term borrowing	—	—	88
Principal payment on short-term borrowing	—	—	(88)
Proceeds from borrowings under equipment loan	—	—	1,216
Principal payments on equipment loan	—	—	(1,216)
Net cash provided by financing activities	6,607	477	63,447
Net increase (decrease) in cash and cash equivalents	(2,743)	(6,141)	7,757
Cash and cash equivalents, beginning of period	10,500	12,735	—
Cash and cash equivalents, end of period	\$7,757	\$6,594	\$7,757

the accompanying notes are an integral part of these consolidated financial statements.

NOVABAY PHARMACEUTICALS, INC.

(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

NOTE 1. ORGANIZATION

NovaBay Pharmaceuticals, Inc. (“we,” “NovaBay” or the “Company”) is a clinical-stage biopharmaceutical company focused on addressing the large unmet therapeutic needs of the global anti-infective market.

The Company was incorporated under the laws of the State of California on January 19, 2000, as NovaCal Pharmaceuticals, Inc. We had no operations until July 1, 2002, on which date we acquired all of the operating assets of NovaCal Pharmaceuticals, LLC, a California limited liability company. In February 2007, we changed our name from NovaCal Pharmaceuticals, Inc. to NovaBay Pharmaceuticals, Inc. In August 2007, we formed two subsidiaries—NovaBay Pharmaceuticals Canada, Inc., a wholly-owned subsidiary incorporated under the laws of British Columbia (Canada), which was formed to conduct research and development in Canada which was dissolved in July 2012, and DermaBay, Inc., a wholly-owned U.S. subsidiary, which may explore and pursue dermatological opportunities. In June 2010, we changed the state in which we are incorporated (the Reincorporation), and are now incorporated under the laws of the State of Delaware. All references to “we,” “us,” “our,” or “the Company” herein refer to the California corporation prior to the date of the Reincorporation, and to the Delaware corporation on and after the date of the Reincorporation. We currently operate in four business segments; see Note 10 for further details.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying unaudited consolidated financial statements of NovaBay Pharmaceuticals, Inc. have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission (“SEC”) for interim reporting including the instructions to Form 10-Q and Rule 8-03 of Regulation S-X. These statements do not include all disclosures for annual audited financial statements required by accounting principles generally accepted in the United States of America (“U.S. GAAP”) and should be read in conjunction with the Company’s audited consolidated financial

statements and related notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2013. The consolidated balance sheet at December 31, 2013, has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required by U.S. GAAP for complete financial statements.

The Company believes these consolidated financial statements reflect all adjustments (consisting only of normal, recurring adjustments) that are necessary for a fair presentation of the financial position and results of operations for the periods presented. Results of operations for the interim periods presented are not necessarily indicative of results to be expected for the year.

The financial statements have been prepared under the guidelines for Development Stage Entities. A development stage enterprise is one in which planned principal operations have not commenced, or if its operations have commenced, there have been no significant revenues therefrom. As of June 30, 2014, we continued to conduct clinical trials and had not commenced our planned principal operations.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, NovaBay Pharmaceuticals Canada, Inc. (prior to its dissolution in July 2012) and DermaBay, Inc. All inter-company accounts and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in accordance with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. These estimates include useful lives for property and equipment and related depreciation calculations, estimated amortization period for payments received from product development and license agreements as they relate to revenue recognition, assumptions for valuing options and warrants, and income taxes. Actual results could differ from those estimates.

Cash, Cash Equivalents and Short-Term Investments

The Company considers all highly liquid instruments with a stated maturity of three months or less at the date of purchase to be cash and cash equivalents. Cash and cash equivalents are stated at cost, which approximates their fair value. As of June 30, 2014, the Company's cash and cash equivalents were held in financial institutions in the United States and include deposits in money market funds, which were unrestricted as to withdrawal or use.

NOVABAY PHARMACEUTICALS, INC.

(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The Company classifies all highly liquid investments with a stated maturity of greater than three months at the date of purchase as short-term investments. Short-term investments generally consist of municipal and corporate debt securities. The Company has classified its short-term investments as available-for-sale. The Company does not intend to hold securities with stated maturities greater than twelve months until maturity. In response to changes in the availability of and the yield on alternative investments as well as liquidity requirements, the Company occasionally sells these securities prior to their stated maturities. These securities are carried at fair value, with the unrealized gains and losses reported as a component of other comprehensive income (loss) until realized. Realized gains and losses from the sale of available-for-sale securities, if any, are determined on a specific identification basis. A decline in the market value below cost of any available-for-sale security that is determined to be other-than-temporary results in a revaluation of its carrying amount to fair value and an impairment charge to earnings, resulting in a new cost basis for the security. No such impairment charges were recorded for the periods presented. The interest income and realized gains and losses are included in other income (expense), net within the consolidated statements of operations and comprehensive loss. Interest income is recognized when earned.

Concentrations of Credit Risk and Major Partners

Financial instruments which potentially subject us to significant concentrations of credit risk consist primarily of cash and cash equivalents and short-term investments. The Company maintains deposits of cash, cash equivalents and short-term investments with three highly-rated, major financial institutions in the United States.

Deposits in these banks may exceed the amount of federal insurance provided on such deposits. The Company does not believe it is exposed to significant credit risk due to the financial position of the financial institutions in which these deposits are held. Additionally, the Company has established guidelines regarding diversification and investment maturities, which are designed to maintain safety and liquidity.

During three months ended June 30, 2014, revenues were derived from one distribution partner, service revenues and sales of NeutroPhase. During three months ended June 30, 2013, revenues were derived from two collaboration partners, two distribution partners, service revenues and sales of NeutroPhase.

During six months ended June 30, 2014, revenues were derived from one collaboration partner, two distribution partners, service revenues and sales of NeutroPhase. During six months ended June 30, 2013, revenues were derived from two collaboration partners, two distribution partners, service revenues and sales of NeutroPhase.

As of June 30, 2014, 66% and 14% of accounts receivable was derived from two distribution partners. As of December 31, 2013, 98% of accounts receivable was derived from one collaboration partner and one distribution partner.

Comprehensive Income (Loss)

ASC 220, *Comprehensive Income* requires that an entity's change in equity or net assets during a period from transactions and other events from non-owner sources be reported. The Company reports unrealized gains and losses on its available-for-sale securities as other comprehensive income (loss).

Fair Value of Financial Assets and Liabilities

Financial instruments, including cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities are carried at cost, which management believes approximates fair value due to the short-term nature of these instruments. Short-term investments and our warrant liability are carried at fair value.

The Company measures the fair value of financial assets and liabilities based on U.S. GAAP guidance which defines fair value, establishes a framework for measuring fair value, and requires disclosures about fair value measurements.

Under U.S. GAAP, fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. A fair value hierarchy is also established, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. There are three levels of inputs that may be used to measure fair value:

Level 1 – quoted prices in active markets for identical assets or liabilities;

Level 2 – quoted prices for similar assets and liabilities in active markets or inputs that are observable;

Level 3 – inputs that are unobservable (for example cash flow modeling inputs based on assumptions).

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NOVABAY PHARMACEUTICALS, INC.

(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Property and Equipment

Property and equipment are stated at cost, less accumulated depreciation and amortization. Depreciation is calculated using the straight-line method over the estimated useful lives of the related assets of five to seven years for office and laboratory equipment, three years for software and seven years for furniture and fixtures. Leasehold improvements are depreciated over the shorter of seven years or the lease term. Depreciation of assets recorded under capital leases is included in depreciation expense.

The costs of normal maintenance, repairs, and minor replacements are charged to operations when incurred.

Impairment of Long-Lived Assets

The Company accounts for long-lived assets in accordance with U.S. GAAP, which requires that companies consider whether events or changes in facts and circumstances, both internally and externally, may indicate that an impairment of long-lived assets held for use are present. Management periodically evaluates the carrying value of long-lived assets and has determined that there was no impairment as of all periods presented. Determination of recoverability is based on the estimate of undiscounted future cash flows resulting from the use of the asset and its eventual disposition. In the event that such cash flows are not expected to be sufficient to recover the carrying amount of the asset, the assets are written down to their estimated fair values and the loss is recognized in the statements of operations.

Revenue Recognition

License and collaboration revenue is primarily generated through agreements with strategic partners for the development and commercialization of the Company's product candidates. The terms of the agreements typically include non-refundable upfront fees, funding of research and development activities, payments based upon achievement of certain milestones and royalties on net product sales. In accordance with revenue recognition criteria under U.S. GAAP, the Company analyzes its multiple element arrangements to determine whether the elements can be separated. The Company performs its analysis at the inception of the arrangement and as each product or service is delivered. If a product or service is not separable, the combined deliverables are

accounted for as a single unit of accounting and revenue is recognized over the performance obligation period. Revenue is recognized when the following criteria have been met: persuasive evidence of an arrangement exists; delivery has occurred and risk of loss has passed; the seller's price to the buyer is fixed or determinable; and collectability is reasonably assured.

Assuming the elements meet the revenue recognition guidelines the revenue recognition methodology prescribed for each unit of accounting is summarized below:

Upfront Fees—The Company defers recognition of non-refundable upfront fees if it has continuing performance obligations without which the technology licensed has no utility to the licensee. If it has performance obligations through research and development services that are required because its know-how and expertise related to the technology is proprietary to it, or can only be performed by it, then such up-front fees are deferred and recognized over the period of the performance obligations. The Company bases the estimate of the period of performance on factors in the contract. Actual time frames could vary and could result in material changes to its results of operations.

Funded Research and Development— Revenue from research and development services is recognized during the period in which the services are performed and is based upon the number of full-time-equivalent personnel working on the specific project at the agreed-upon rate. This revenue approximates the cost incurred. Reimbursements from collaborative partners for agreed-upon direct costs including direct materials and outsourced, or subcontracted, pre-clinical studies are classified as revenue and recognized in the period the reimbursable expenses are incurred. Payments received in advance are recorded as deferred revenue until the research and development services are performed or costs are incurred.

Milestones—Substantive milestone payments are considered to be performance bonuses that are recognized upon achievement of the milestone only if all of the following conditions are met: the milestone payments are non-refundable; achievement of the milestone involves a degree of risk and was not reasonably assured at the inception of the arrangement; substantive effort is involved in achieving the milestone; the amount of the milestone is reasonable in relation to the effort expended or the risk associated with achievement of the milestone; and a reasonable amount of time passes between the up-front license payment and the first milestone payment as well as between each subsequent milestone payment. If any of these conditions are not met, the milestone payments are deferred and recognized as revenue over the term of the arrangement as we complete our performance obligations.

Royalties—The Company recognizes royalty revenues from licensed products upon the sale of the related products.

NOVABAY PHARMACEUTICALS, INC.

(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Product Sales—The Company sells NeutroPhase, CelleRx and i-Lid Cleanser through a limited number of distributors. We generally record product sales upon shipment to distributors at which time title and risk of loss pass to the distributors.

Cost of Goods Sold

Cost of goods sold includes third party manufacturing costs, shipping costs, cost of samples and other costs of goods sold. Cost of goods sold also includes any necessary allowances for excess inventory that may expire and become unsalable.

Research and Development Costs

The Company charges research and development costs to expense as incurred. These costs include salaries and benefits for research and development personnel, costs associated with clinical trials managed by contract research organizations, and other costs associated with research, development and regulatory activities. The Company uses external service providers to conduct clinical trials, to manufacture supplies of product candidates and to provide various other research and development-related products and services. Research and development expenses under the collaborative agreements approximate the revenue recognized, excluding milestone and upfront payments received under such arrangements.

Patent Costs

Patent costs, including legal expenses, are expensed in the period in which they are incurred. Patent expenses are included in general and administrative expenses in the consolidated statements of operations and comprehensive loss.

Stock-Based Compensation

The Company accounts for stock-based compensation under the provisions of ASC 718, *Compensation-Stock Compensation*. Under the fair value recognition provisions, stock-based compensation expense is measured at the grant date for all stock-based awards to employees and directors and is recognized as expense over the requisite service period, which is generally the vesting period. Non-employee stock-based compensation charges are amortized over the vesting period on a straight-line basis. For stock options granted, the fair value of the stock options is estimated using a Black-Scholes-Merton option pricing model. See Note 8 for further information regarding stock-based compensation expense and the assumptions used in estimating that expense.

Income Taxes

The Company accounts for income taxes under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is recognized if it is more likely than not that some portion or the entire deferred tax asset will not be recognized.

Common Stock Warrant Liabilities

For warrants where there is a deemed possibility that the Company may have to settle the warrants in cash, the Company records the fair value of the issued warrants as a liability at each balance sheet date and records changes in the estimated fair value as a non-cash gain or loss in the consolidated statement of operations and comprehensive loss. The fair values of these warrants have been determined using the Binomial Lattice (“Lattice”) valuation model. The Lattice model provides for assumptions regarding volatility, call and put features and risk-free interest rates within the total period to maturity. These values are subject to a significant degree of judgment on the part of the Company.

Net Income (Loss) per Share

The Company computes net income (loss) per share by presenting both basic and diluted earnings (loss) per share (EPS).

NOVABAY PHARMACEUTICALS, INC.**(a development stage company)****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

Basic EPS is computed by dividing net income (loss) available to common shareholders by the weighted average number of common shares outstanding during the period. Diluted EPS gives effect to all dilutive potential common shares outstanding during the period including stock options and warrants, using the treasury stock method, using the if-converted method. In computing diluted EPS, the average stock price for the period is used in determining the number of shares assumed to be purchased from the exercise of stock options or warrants. Potentially dilutive common share equivalents are excluded from the diluted EPS computation in net loss periods since their effect would be anti-dilutive. During the three months ended June 30, 2014 and 2013, and six months ended June 30, 2014 and 2013, there was no difference between basic and diluted net loss per share due to the Company's net losses. The following table sets forth the calculation of basic EPS and diluted EPS:

(in thousands, except per share amounts)	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Net loss	\$ (2,942)	\$ (4,048)	\$ (6,507)	\$ (8,057)
Basic shares	50,767	37,266	48,067	37,013
Add: shares issued upon assumed exercise of stock options and warrants	—	—	—	—
Diluted shares	50,767	37,266	48,067	37,013
Basic and diluted net loss per share	\$ (0.06)	\$ (0.11)	\$ (0.14)	\$ (0.22)

The following outstanding stock options and stock warrants were excluded from the diluted net loss per share computation as their effect would have been anti-dilutive:

**Six Months
Ended
June 30,**

(In thousands)	2014	2013
Stock options	7,473	6,564
Stock warrants	6,165	11,210
	13,638	17,774

Recent Accounting Pronouncements

In May 2014, Financial Accounting Standards Board (the “FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09 “Revenue from Contracts with Customers” (Topic 606). The guidance of this Update effects any entities that either issues contracts with customers or transfer goods or services or enters into contracts for the transfer of non-financial assets. The core principal of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in the amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. To achieve those core principals, the ASU specifies steps that the entity should apply for revenue recognition. The guidance also specifies the accounting for some costs to obtain or fulfill the contract with customer and disclosure requirements to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. For a public entity, ASU No. 2014-10 is effective for annual reporting period beginning after December 15, 2016, including interim periods within that reporting period. Early application is not permitted. The Company will adopt ASU No. 2014-09 on January 1, 2017. The Company is currently evaluating the impact of the adoption of the ASU on its consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-10 “Development Stage Entities” (Topic 915). The objective of the ASU is to improve financial reporting by reducing the cost and complexity of associated with the incremental reporting requirements for development stage entities. The ASU removes all incremental financial reporting requirements from U.S. GAAP for development stage entities, including the inception-to-date information and certain other disclosures. The ASU also eliminates an exception provided to development stage entities in Topic 810 “Consolidation” for determining whether an entity is a variable interest entity on the basis of amount of investment equity at risk. For public business entities, those amendments are effective for annual reporting periods beginning after December 15, 2014, and interim periods therein. Early application of the amendments is permitted for any annual or interim reporting period for which the entity’s financial statements have not been issued. The Company will adopt ASU No. 2014-10 on January 1, 2015. The adoption will have a material impact on the Company’s consolidated financial statements. The Company will no longer present incremental disclosure for development stage entities in its Annual Report on Form 10-K for the year ended December 31, 2014 and subsequently issued Forms 10-Q and 10-K, including consolidated financial statements for cumulative period from July 1, 2002 (inception) to the reporting date and inception-to-date disclosures.

NOVABAY PHARMACEUTICALS, INC.**(a development stage company)****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

In June 2014, the FASB issued ASU No. 2014-12 “Compensation – Stock Compensation” (Topic 718). The ASU provides guidance for accounting for share-based payments when the terms of an award provide that a performance target could be achieved after the requisite service period. That is the case than an employee is eligible to retire or otherwise terminate employment before the end of the period in which a performance target (for example, profitability target) could be achieved and still be eligible to vest in the award if and when the performance target is achieved. The amendment requires a performance target that effects vesting and that could be achieved after requisite service period be treated as a performance condition. Compensation cost should be recognized in the period in which it becomes probable that such performance condition would be achieved and should represent the compensation cost attributable to the periods for which the requisite service has already been rendered. For public business entities, those amendments are effective for annual reporting periods beginning after December 15, 2015, and interim periods therein. Early application is permitted. The Company will adopt ASU No. 2014-12 on January 1, 2016. The adoption will not have a material impact on the Company’s consolidated financial statements, as the Company currently does not have share-based payment awards, which are subject to ASU No. 2014-12.

NOTE 3. INVESTMENTS

Short-term investments at June 30, 2014, and December 31, 2013, consisted of the following:

	June 30, 2014			
	Amortized	Gross	Gross	Market
(in thousands)	Cost	Unrealized	Unrealized	Value
		Gains	Losses	
Corporate bonds	\$871	\$	— \$ (11) \$ 860
Municipal bonds			—	—
Certificates of deposit	\$2,950	\$	— \$ (2) \$ 2,948
	\$3,821	\$	— \$ (13) \$ 3,808

December 31, 2013

(in thousands)	Gross		Gross		Market Value
	Amortized Cost	Unrealized Gains	Unrealized Losses		
Corporate bonds	\$518	\$	— \$ (14)	\$504
Certificates of deposit	2,050		— (1)	2,049
	\$2,568	\$	— \$ (15)	\$2,553

All short-term investments at June 30, 2014, and December 31, 2013, mature in less than one year. Unrealized holding gains and losses classified as available-for-sale are recorded in accumulated other comprehensive loss.

The Company recognized realized losses of \$10,000 and \$5,000, for the three months ended June 30, 2014 and 2013, respectively. The Company recognized realized losses of \$19,000 and \$14,000, for the six months ended June 30, 2014 and 2013, respectively.

NOTE 4. FAIR VALUE MEASUREMENTS

The Company's cash equivalents and investments are classified within Level 1 or Level 2 of the fair value hierarchy because they are valued using quoted market prices in active markets, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency. The types of investments that are generally classified within Level 1 of the fair value hierarchy include money market securities. The types of investments that are generally classified within Level 2 of the fair value hierarchy include corporate and municipal securities and certificates of deposits.

The Company's warrant liabilities are classified within level 3 of the fair value hierarchy because the value is calculated using significant judgment based on our own assumptions in the valuation of these liabilities.

NOVABAY PHARMACEUTICALS, INC.**(a development stage company)****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

The following table presents the Company's assets and liabilities measured at fair value on a recurring basis as of June 30, 2014:

(in thousands)	Fair Value Measurements Using			
	Balance at June 30, 2014	Quoted Prices in Active Markets for Identical Items (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Short-term investments:				
Corporate bonds	860	—	860	—
Certificates of deposit	2,948	—	2,948	—
Total short-term investments	3,808	—	3,808	—
Total assets	\$3,808	\$ —	\$ 3,808	\$ —
Liabilities				
Warrant liability	\$520	\$ —	\$ —	\$ 520
Total liabilities	\$520	\$ —	\$ —	\$ 520

For the three and six month periods ended June 30, 2014, as a result of the fair value adjustment of the warrant liability, the Company recorded a noncash gain on a decrease in the fair value of the warrants of \$797,000 and \$1,317,000, respectively, in its consolidated statement of operations and comprehensive loss.

For the three and six month periods ended June 30, 2013, as a result of the fair value adjustment of the warrant liability, the Company recorded a noncash gain (loss) on an (increase) decrease in the fair value of the warrants of

\$104,000 and \$(416,000), respectively, in its consolidated statement of operations and comprehensive loss. See Note 6 for further discussion on the calculation of the fair value of the warrant liability.

(in thousands)	Warrant liability
Fair value of warrants at December 31, 2013	\$ 1,837
Adjustment to fair value at June 30, 2014	(1,317)
Total warrant liability at June 30, 2014	\$ 520

NOTE 5. COMMITMENTS AND CONTINGENCIES

Operating Leases

The Company leases laboratory facilities and office space under an operating lease which will expire on October 31, 2020. Rent expense was approximately \$280,000 and \$246,000 for the three months ended June 30, 2014 and 2013, respectively. Rent expense was approximately \$535,000 and \$465,000 for the six months ended June 30, 2014 and 2013, respectively

The Company's monthly rent payments fluctuate under the master lease agreement. In accordance with U.S. GAAP, the Company recognizes rent expense on a straight-line basis. The Company records deferred rent for the difference between the amounts paid and recorded as expense.

Directors and Officers Indemnity

As permitted under Delaware law and in accordance with its bylaws, the Company shall indemnify its officers and directors for certain events or occurrences while the officer or director is or was serving at its request in such capacity. The term of the indemnification period is for the officer's or director's lifetime. The maximum amount of potential future indemnification is unlimited; however, the Company has a director or officer insurance policy that limits its exposure and may enable them to recover a portion of any future payments. The Company believes the fair value of these indemnification agreements is minimal. Accordingly, no liability has been recorded for these agreements as of June 30, 2014.

In the normal course of business, the Company provides indemnifications of varying scope under agreements with other companies, typically its clinical research organizations, investigators, clinical sites, suppliers and others.

Pursuant to these agreements, the Company generally indemnifies, holds harmless, and agrees to reimburse the indemnified parties for losses suffered or incurred by the indemnified parties in connection with use or testing of its products or product candidates or with any U.S. patent or any copyright or other intellectual property infringement claims by any third party with respect to their products. The term of these indemnification agreements is generally perpetual. The potential future payments the Company could be required to make under these indemnification agreements is unlimited. Historically, costs related to these indemnification provisions have been immaterial. The Company also maintains various liability insurance policies that limit its exposure. As a result, the Company believes the fair value of these indemnification agreements is minimal. Accordingly, no liabilities have been recorded for these agreements as of June 30, 2014.

NOVABAY PHARMACEUTICALS, INC.

(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Legal Matters

From time to time, the Company may be involved in various legal proceedings arising in the ordinary course of business. There are no matters at June 30, 2014, that, in the opinion of management, would have a material adverse effect on the Company's financial position, results of operations or cash flows.

NOTE 6. WARRANT LIABILITY

In July 2011, the Company sold common stock and warrants in a registered direct financing. As part of this transaction, 3,488,005 warrants were issued with an exercise price of \$1.33 and were exercisable on January 1, 2012, and expire on July 5, 2016. The terms of the warrants require registered shares to be delivered upon each warrant's exercise and also require possible cash payments to the warrant holders (in lieu of the warrant's exercise) upon specified fundamental transactions involving the Company's common stock, such as in an acquisition of the Company. Under ASC 480, "Distinguishing Liabilities from Equity" ("ASC 480"), the Company's ability to deliver registered shares upon an exercise of the warrants and the Company's potential obligation to cash-settle the warrants if specified fundamental transactions occur are deemed to be beyond the Company's control. The warrants contain a provision where the warrant holder would have the option to receive cash, equal to the Black-Scholes fair value of the remaining unexercised portion of the warrant, as cash settlement in the event that there is a fundamental transaction (contractually defined to include various merger, acquisition or stock transfer activities). Due to this provision, ASC 480 requires that these warrants be classified as liabilities. The fair values of these warrants have been determined using the Binomial Lattice ("Lattice") valuation model, and the changes in the fair value are recorded in the consolidated statement of operations and comprehensive loss. The Lattice model provides for assumptions regarding volatility and risk-free interest rates within the total period to maturity. In addition, after January 5, 2012, and if the closing bid price per share of the common stock on the principal market equals or exceeds \$2.66 for any ten trading days (which do not need to be consecutive) in a period of fifteen consecutive trading days, the Company has the right to require the exercise of one-third of the warrants then held by the warrant holders, which would result in gross proceeds to the Company of approximately \$1.5 million.

The key assumptions used to value the warrants were as follows:

<u>Assumption</u>	June 30,	
	2014	2013
Expected price volatility	70 %	55 %
Expected term (in years)	2.01	3.01
Risk-free interest rate	0.48%	0.67%
Dividend yield	0.00%	0.00%
Weighted-average fair value of warrants	\$0.15	\$0.49

NOTE 7. STOCKHOLDERS' EQUITY

On July 5, 2011, the Company closed a registered direct offering for the sale of 4,650,675 units (The "July 2011 Registered Direct Financing"), each unit consisting of (i) one share of common stock and (ii) one warrant to purchase 0.75 of a share of common stock (or a total of 3,488,005 shares), at a purchase price of \$1.11 per unit. The warrants will be exercisable 180 days after issuance for \$1.33 per share and will expire five years from the date of issuance. All of the shares of common stock and warrants issued in the offering (and the shares of common stock issuable upon exercise of the warrants) were offered pursuant to a shelf registration statement filed with, and declared effective by, the Securities and Exchange Commission. The shares of common stock and the warrants were immediately separable and were issued separately, but were purchased together in the July 2011 Registered Direct Offering. The Company raised a total of \$5.2 million from the July 2011 Registered Direct Financing, or approximately \$4.6 million in net proceeds after deducting underwriting commissions of \$288,000 and other offering costs of \$244,000.

NOVABAY PHARMACEUTICALS, INC.

(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

On December 6, 2012, the Company closed a public offering for the sale of 5,900,000 shares of common stock and 5,900,000 warrants to purchase 0.75 of a share of common stock (or a total of 4,425,000 shares), at a purchase price of \$1.25 per share with associated warrant. The warrants were immediately exercisable for \$1.50 per share and will expire one year from the date of issuance. All of the shares of common stock and warrants issued in the offering (and the shares of common stock issuable upon exercise of the warrants) were offered pursuant to a shelf registration statement filed with, and declared effective by, the Securities and Exchange Commission. The shares of common stock and the warrants were immediately separable and were issued separately, but were purchased together. The Company raised a total of \$7.4 million from this offering, or approximately \$6.6 million in net proceeds after deducting underwriting commissions of \$479,000 and other offering costs of \$240,000.

On November 14, 2013, the Company entered into an At-The-Market Offering Agreement (“ATM Agreement”), with Ascendant Capital Markets (“Ascendant”), as its agent, and filed a prospectus supplement to its shelf registration statement, pursuant to which the Company may offer and sell shares of our common stock having an aggregate offering price of up to \$5.0 million from time to time. For the year ended December 31, 2013, the Company sold 289,492 shares for gross proceeds of \$378,000, or approximately \$352,000 in net proceeds after deducting offering costs and commissions of \$26,000. For the six months ended June 30, 2014, the Company sold 436,153 shares for gross proceeds of \$536,000, or approximately \$473,000 in net proceeds after deducting offering costs and commissions of \$63,000. Under the terms of the ATM Agreement, the Company pays to Ascendant 3% of the gross proceeds of any sales made under the prospectus supplement.

On December 2, 2013 the Company entered into a stock purchase agreement with Pioneer to purchase five million shares of NovaBay stock at \$1.14 per share, resulting in cash proceeds to NovaBay of \$5.7 million.

On March 25, 2014, the Company closed a public offering for the sale of 5,600,000 units, each unit consisting of (i) one share of common stock and (ii) one warrant to purchase 0.25 of a share of common stock (or a total of 1,400,000 shares), at a purchase price of \$1.20 per unit. The warrants were immediately exercisable for \$1.56 per share and will expire eighteen months from the date of issuance. All of the shares of common stock and warrants issued in the offering (and the shares of common stock issuable upon exercise of the warrants) were offered pursuant to a shelf registration statement filed with, and declared effective by, the Securities and Exchange Commission. The shares of common stock and the warrants were immediately separable and were issued separately, but were purchased

together. The Company raised a total of \$6.7 million from this offering, or approximately \$6.0 million in net proceeds after deducting underwriting commissions of \$470,000 and other offering costs of \$211,000.

Stock Warrants

At June 30, 2014, there were outstanding warrants to purchase 1,225,000 shares of common stock, issued in connection with our August 2009 shelf offering, with an exercise price of \$2.75 per share expiring on August 21, 2014. These outstanding warrants were exercisable at June 30, 2014.

In July 2011, 3,488,005 warrants were issued in connection with our July 2011 Registered Direct Financing. These warrants were issued with an exercise price of \$1.33 and expire on July 5, 2016. These outstanding warrants were fully exercisable at June 30, 2014. During 2012, 22,500 of these warrants were exercised and the Company received \$30,000 in cash upon exercise of the warrants.

In January 2012, warrants to purchase 60,000 shares were issued to a vendor. These warrants were issued with an exercise price of \$2.50 per share for 30,000 of the shares and \$3.75 per share for the remaining 30,000 shares and became exercisable monthly through June 30, 2012, were fully exercisable on June 30, 2014, and expire on January 2, 2016. The warrants were valued at approximately \$34,000 using the Black-Scholes-Merton option-pricing model based upon the following assumptions: (1) expected price volatility of 75% and 89%, respectively, (2) a risk-free interest rate of 0.30% and 0.36% respectively and (3) an expected life of 2.36 and 2.98 years, respectively. The Company accounts for the fair value of these warrants as an expense amortized over the vesting period of the warrants. The Company recognized no expense during the three and six months ended June 30, 2014 and 2013, related to these warrants.

In October 2012, warrants to purchase 15,000 shares were issued to a vendor. These warrants were issued with an exercise price of \$2.50 per share and 5,000 shares became exercisable on each of October 30, 2012, November 30, 2012, and December 30, 2012, and they all expire on September 30, 2014. The warrants were valued at approximately \$4,000 using the Black-Scholes-Merton option-pricing model based upon the following assumptions: (1) expected price volatility of 72%, (2) a risk-free interest rate of 0.27% and (3) an expected life of 2.00 years. The Company accounts for the fair value of these warrants as an expense amortized over the vesting period of the warrants. The Company recognized no expense during the three and six months ended June 30, 2014 and 2013, related to these warrants.

In March 2014, 1,400,000 warrants were issued in connection with our March Financing. These warrants were issued with an exercise price of \$1.56 and expire on September 25, 2015. These outstanding warrants were fully exercisable at June 30, 2014.

NOVABAY PHARMACEUTICALS, INC.**(a development stage company)****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

The details of all outstanding warrants as of June 30, 2014, are as follows:

(in thousands, except per share data)	Warrants	Weighted-Average Exercise Price
Outstanding at December 31, 2013	4,765	\$ 1.72
Warrants issued	1,400	\$ 1.56
Outstanding at June 30, 2014	6,165	\$ 1.68

NOTE 8. EQUITY-BASED COMPENSATION***Equity Compensation Plans***

Prior to our Initial Public Offering (IPO), the Company had two equity plans in place: the 2002 Stock Option Plan and the 2005 Stock Option Plan. Upon the closing of the IPO in October 2007, the Company adopted the 2007 Omnibus Incentive Plan (the “2007 Plan”) to provide for the granting of stock awards, such as stock options, unrestricted and restricted common stock, stock units, dividend equivalent rights, and stock appreciation rights to employees, directors and outside consultants as determined by the board of directors. In conjunction with the adoption of the 2007 Plan, no further option awards may be granted from the 2002 or 2005 Stock Option Plans and any option cancellations or expirations from the 2002 or 2005 Stock Option Plans may not be reissued. As of June 30, 2014, there were 1,313,995 shares available for future grant under the 2007 Plan.

Under the terms of the 2007 Plan, the exercise price of incentive stock options may not be less than 100% of the fair market value of the common stock on the date of grant and, if granted to an owner of more than 10% of the Company’s stock, then not less than 110%. Stock options granted under the 2007 Plan expire no later than ten years from the date of grant. Stock options granted to employees generally vest over four years while options granted to directors and consultants typically vest over a shorter period, subject to continued service. All of the options granted prior to October 2007 include early exercise provisions that allow for full exercise of the option prior to the option vesting,

subject to certain repurchase provisions. The Company issues new shares to satisfy option exercises under the plans.

Stock Based Compensation Summary

The following table summarizes information about the Company's stock options and restricted stock units outstanding at June 30, 2014, and activity during the six-month period then ended:

(in thousands, except years and per share data)	Stock Awards	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life (years)	Aggregate Intrinsic Value
Outstanding at December 31, 2013	7,164	\$ 1.66		
Options granted	766	\$ 1.08		
Restricted stock units granted	71	\$ —		
Options exercised	(61)	\$ 0.56		
Restricted stock units vested	(56)	\$ —		
Restricted stock units forfeited/cancelled	(3)	\$ —		
Options forfeited/cancelled	(333)	\$ 1.12		
Outstanding at June 30, 2014	7,548	\$ 1.63	6.36	\$ 65
Vested and expected to vest at June 30, 2014	7,160	\$ 1.66	6.23	\$ 59
Vested at June 30, 2014	5,507	\$ 1.75	5.47	\$ 16
Exercisable at June 30, 2014	5,507	\$ 1.75	5.47	\$ 16

As of June 30, 2014, total unrecognized compensation cost related to unvested stock options and restricted stock units was \$1.3 million. This amount is expected to be recognized as stock-based compensation expense in the Company's consolidated statements of operations and comprehensive loss over the remaining weighted average vesting period of 2.55 years.

NOVABAY PHARMACEUTICALS, INC.**(a development stage company)****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)***Stock Options and Awards to Employees and Directors*

The Company grants options to purchase common stock to its employees and directors at prices equal to or greater than the market value of the stock on the dates the options are granted. The Company has estimated the value of stock option awards as of the date of grant by applying the Black-Scholes-Merton option pricing model using the single-option valuation approach. The application of this valuation model involves assumptions that are judgmental and subjective in nature. See Note 2 for a description of the accounting policies that the Company applied to value its stock-based awards.

During the six months ended June 30, 2014 and 2013, the Company granted options to purchase an aggregate of 574,000 and 797,000 shares of common stock, respectively, to employees.

The weighted-average assumptions used in determining the value of options are as follows:

<u>Assumption</u>	Six months ended June 30,	
	2014	2013
Expected price volatility	73 %	86 %
Expected term (in years)	5.59	4.97
Risk-free interest rate	1.80%	0.80%
Dividend yield	0.00%	0.00%
Weighted-average fair value of options granted during the period	\$0.70	\$0.79

Additionally, during the six months ended June 30, 2014 and 2013, the Company issued 48,267 and 0 shares of common stock, respectively, to employees.

For the three months ended June 30, 2014 and 2013, the Company recognized stock-based compensation expense of \$197,000 and \$295,000, respectively, for stock and option grants to employees and directors. For the six months ended June 30, 2014 and 2013, the Company recognized stock-based compensation expense of \$442,000 and \$511,000, respectively, for stock and option grants to employees and directors.

Stock-Based Awards to Non-Employees

During the six months ended June 31, 2014 and 2013, the Company granted options to purchase an aggregate of 193,000 and 81,500 shares of common stock, respectively, to non-employees in exchange for advisory and consulting services. The stock options are recorded at their fair value on the measurement date and recognized over the respective service or vesting period. The fair value of the stock options granted was calculated using the Black-Scholes-Merton option pricing model based upon the following assumptions:

<u>Assumption</u>	Six Months Ended June 30,	
	2014	2013
Expected price volatility	79 %	76 %
Expected term (in years)	8.56	8.78
Risk-free interest rate	2.42%	2.00%
Dividend yield	0.00%	0.00%
Weighted-average fair value of options granted during the period	\$0.72	\$0.99

Additionally, during the six months ended June 31, 2014 and 2013, the Company issued 30,000 and 33,000 shares of common stock, respectively, to non-employees in exchange for services.

For the three months ended June 30, 2014 and 2013, the Company recognized stock-based compensation expense of \$50,000 and \$23,000, respectively, related to non-employee stock and option grants. For the six months ended June 30, 2014 and 2013, the Company recognized stock-based compensation expense of \$82,000 and \$69,000, respectively, related to non-employee stock and option grants.

Summary of Stock-Based Compensation Expense

Stock-based compensation expense is classified in the consolidated statements of operations and comprehensive loss in the same expense line items as cash compensation. Since the Company continues to operate at a net loss, it does not expect to realize any current tax benefits related to stock options.

NOVABAY PHARMACEUTICALS, INC.**(a development stage company)****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

A summary of the stock-based compensation expense included in the consolidated statement of operations and comprehensive loss for the options and stock discussed above is as follows:

(in thousands)	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2014	2013	2014	2013
Research and development	\$49	\$166	\$125	\$252
General and administrative	198	152	399	328
Total stock-based compensation expense	\$247	\$318	\$524	\$580

NOTE 9. LICENSE, COLLABORATION AND DISTRIBUTION AGREEMENTS*Galderma*

On March 25, 2009, the Company entered into a collaboration and license agreement with Galderma S.A. to develop and commercialize the Company's Aganocide compounds, which covers acne and impetigo and potentially other major dermatological conditions, excluding onychomycosis (nail fungus), orphan drug indications and most post surgical use and use in wound care. The Company amended this agreement in December 2009 and again in December 2010. Based on the Impetigo Phase 2a clinical trial results, in December 2010, Galderma S.A., exercised the option to continue with the development of impetigo and initiated a Phase 2 study. In November 2013, the Company announced that the auriclosene Phase 2b clinical study of impetigo had been completed. While the study showed that auriclosene is safe and well tolerated, it did not meet its primary clinical endpoint. Knowledge gained from two previous impetigo studies is expected to lead to the use of an optimized formulation of auriclosene for an upcoming pilot study which the Company is current planning to conduct in the second half of 2014. Upon initiation of this study, the Company will be responsible the planning, execution and the cost which is expect to be approximately \$1 to \$2 million. Based on the results of this pilot study NovaBay and Galderma will determine the next steps in the development of auriclosene for this indication.

Galderma is responsible for the development costs of product candidate compounds, except for costs incurred in Japan and for the pilot study noted above. In Japan, Galderma has the option to request that the Company share such development costs. NovaBay retains the right to co-market products resulting from the agreement in Japan. In addition, NovaBay has retained all rights to co-promote the products developed under the agreement in hospitals and other healthcare institutions in North America.

Galderma will pay to NovaBay certain upfront fees, ongoing fees, reimbursements, and milestone payments related to achieving development and commercialization of its Aganocide compounds. If products are commercialized under the agreement, NovaBay's royalties will escalate as sales increase. The Company received a \$1.0 million upfront technology access fee payment in the first quarter of 2009 and a \$3.25 million continuation fee and a \$500,000 fee to expand the license to include the Asia-Pacific Territory in December 2010. These fees were recorded as deferred revenues and recognized as earned on a straight-line basis over the Company's expected performance period. The initial upfront technology access fee was recognized over the initial 20 month funding term of the agreement through October 2010, and the continuation and license fees were recognized over the additional three year funding term of the agreement through November 2013.

Revenue has been recognized under the Galderma agreement as follows:

(in thousands)	Three Months Ended	Six Months Ended
	June 30, 2012 2013	June 30, 2014 2013
Amortization of Upfront Technology Access Fee	\$—\$315	\$1 \$630
On-going Research and Development (FTE)	— 409	— 818
Materials, Equipment, and Contract Study Costs	— —	— 11
Total	\$—\$724	\$1 \$1,459

The Company had deferred revenue balances of \$0 and \$1,000 at June 30, 2014, and December 31, 2013, respectively, related to the Galderma agreement, which consisted of the unamortized balances on the upfront technology. As of June 30, 2014, the Company has earned \$4.25 million in milestone payments. As of June 30, 2014, the Company has not earned or received any royalty payments under the Galderma agreement.

NOVABAY PHARMACEUTICALS, INC.**(a development stage company)****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)***Virbac Agreement*

In April 2012, the Company entered into a feasibility and option agreement with Virbac, a global animal health company for the development and potential commercialization of Aganocides for a number of veterinary uses for companion animals. Under the terms of the agreement, NovaBay received an upfront payment and is entitled to additional support for research and development. The company will conduct veterinary studies using NovaBay's Aganocide compounds to assess feasibility for treating several veterinary indications.

In April 2013, the option was exercised and the Company entered into a collaboration and license agreement with Virbac. Under this new agreement Virbac acquired exclusive worldwide rights to develop the Company's proprietary compound, auriclosene (NVC-422), for global veterinary markets for companion animals. The Company received an option exercise fee and may receive future development and pre-commercial milestone payments as a result of the collaboration. The Company also expects to receive royalties on the sale of any commercial products in the companion animal field. Virbac's option exercise follows its extensive testing of auriclosene (NVC-422) for veterinary uses during the 12-month option period. The Company is recognizing the option exercise fee over its expected performance period of 10 years.

Revenue has been recognized under the agreement as follows:

	Three Months Ended	Six Months Ended
	June 30, 2014	June 30, 2013
(in thousands)		
Amortization of Upfront Technology Access Fee	\$ — \$ 4	\$ — \$42
On-going Research and Development (FTE)	— —	— 87
Total	\$ — \$ 4	\$ — \$129

The Company had deferred revenue of \$246,000 at June 30, 2014, and December 31, 2013, respectively, related to this agreement, which consisted of the unamortized balances on the upfront technology access fee and option fee and the support for ongoing research and development.

NeutroPhase Distribution Agreements

In January 2012, the Company entered into a distribution agreement with Pioneer Pharma Co., Ltd., a Shanghai-based company that markets high-end pharmaceutical products into China, for the commercialization of NeutroPhase in this territory. Under the terms of the agreement, NovaBay received an upfront payment of \$312,500. NovaBay also received \$312,500 in January 2013, related to the submission of the first marketing approval for the product to the CFDA (formerly the SFDA, State Food and Drug Administration), which was submitted in December 2012. The distribution agreement provides that Pioneer Pharma Co., Ltd is entitled to receive cumulative purchase discounts of up to \$500,000 upon the purchase of NeutroPhase product. The deferred revenue will be recognized as the purchase discounts are earned, with the remaining deferred revenue recognized ratably over the product distribution period. In addition, NovaBay is entitled to receive \$625,000 upon receipt of an MAA approval of the product from the CFDA.

In September 2012, the Company entered into two agreements with Pioneer Pharma Co., Ltd. (“Pioneer”): (1) an international distribution agreement (“Distribution Agreement”) and (2) a unit purchase agreement (“Purchase Agreement”). These agreements were combined and accounted for as one arrangement with one unit of accounting for revenue recognition purposes.

Pursuant to the terms of the Distribution Agreement, Pioneer has the right to distribute NeutroPhase, upon MAA Approval from a Regulatory Authority, in certain territories in Asia (other than China). Upon execution of the Distribution Agreement, we received an upfront payment, which was recorded as deferred revenue. Pioneer is also obligated to make certain additional payments to us upon receipt of the MAA Approval. The Distribution Agreement further provides that Pioneer is entitled to a cumulative purchase discount not to exceed \$500,000 upon the purchase of NeutroPhase product; payable in NovaBay unregistered restricted common stock.

NOVABAY PHARMACEUTICALS, INC.**(a development stage company)****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

Pursuant to the Purchase Agreement, we also received \$2.5 million from Pioneer for the purchase of restricted units (comprising 1 share of common stock and a warrant for the purchase of 1 share of common stock). The unit purchase was completed in two tranches: (1) 800,000 units in September 2012; and (2) 1,200,000 units in October 2012, with both tranches at a purchase price of \$1.25 per share. The fair value of the total units sold was \$3.5 million, based upon the trading price of our common stock on the dates the units were purchased and fair value of the warrants based on the Black-Scholes Merton option pricing model. Because the aggregate fair value of the units on the dates of purchase exceeded the \$2.5 million in proceeds received from the unit purchase by approximately \$1 million, we reallocated \$600,000 from deferred revenue to stockholders' equity as consideration for the purchase of the units.

In December 2013, the Company announced it had expanded its NeutroPhase commercial partnership agreement with Pioneer. The expanded agreement includes licensing rights to two new products, CelleRx™ and i-Lid™ Cleanser, developed internally by NovaBay. The expanded partnership agreement covers the commercialization and distribution of these products in China and 11 countries in Southeast Asia.

In addition to the Pioneer Pharma agreements, the Company has entered into three other smaller agreements and continues to seek additional distribution agreements.

Revenue has been recognized under these agreements as follows:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
(in thousands)	2014	2013	2014	2013
Amortization of Upfront Technology Access Fee	\$—	\$ 10	\$ 15	\$ 20
On-going Research and Development (FTE)	7	44	29	88
Total	\$ 7	\$ 54	\$ 44	\$ 108

The Company had deferred revenue of \$1.6 million at June 30, 2014, and December 31, 2013, respectively, related to these agreements, which consisted of the unamortized balances on the upfront technology access fee and the support for ongoing research and development.

NOTE 10. SEGMENT INFORMATION

The Company reports financial data for four reportable segments, coinciding with its four business units: dermatology, ophthalmology, urology and wound care. The dermatology segment includes all aspects of its business around the dermatology arena including the collaboration with Galderma and their impetigo clinical trial. The ophthalmology segment includes its clinical trial on ophthalmology which it is conducting on its own at this time. This segment also includes its i-case product which is currently in development phases. The urology segment covers its urinary catheter encrustation and blockage (UCBE) trials. The wound care segment encompasses the business around its NeutroPhase product, which went on the market in December 2012. Its remaining activities are immaterial and are shown as an aggregate.

The Company discloses information about its reportable segments based on the measures it uses in assessing the performance of each segment. The Company uses “segment net income (loss)” to measure the performance of its business units. Segment net income (loss) includes the allocation of certain corporate expense. These expenses have been allocated based on the FTE allocations to each individual segment or business unit.

The Company does not segregate specific assets to each business unit as we do not have a reasonable way to allocate the corporate assets to each unit and the Company does not use this as a measure of segment performance.

NOVABAY PHARMACEUTICALS, INC.**(a development stage company)****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

(in thousands)	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2014	2013	2014	2013
Revenues:				
DermaBay (dermatology)	\$4	\$724	\$5	\$1,459
EyeBay (ophthalmology)	19	—	20	—
UroBay (urology)	—	—	—	—
MediBay (wound care)	7	78	231	195
Other	93	46	155	214
	\$123	\$848	\$411	\$1,868

Segment net income (loss):

DermaBay (dermatology)	\$(330)	\$(342)	\$(605)	\$(316)
EyeBay (ophthalmology)	(1,423)	(1,233)	(3,202)	(2,588)
UroBay (urology)	(722)	(894)	(1,219)	(1,798)
MediBay (wound care)	(1,120)	(1,407)	(2,191)	(2,253)
Other	(191)	(274)	(647)	(682)
	\$(3,786)	\$(4,150)	\$(7,864)	\$(7,637)

A reconciliation of total segment net loss to consolidated net loss is as follows:

(in thousands)	Three Months ended		Six Months ended	
	June 30,		June 30,	
	2014	2013	2014	2013
Segment net loss	(3,786)	(4,150)	(7,864)	(7,637)
Non-cash (gain) loss on change in fair value of warrants	797	104	1,317	(416)
Other income (expense), net	57	5	50	5
Provision for income taxes	(10)	(7)	(10)	(9)
Net loss	\$(2,942)	\$(4,048)	\$(6,507)	\$(8,057)

NOTE 11. SUBSEQUENT EVENTS

We evaluated subsequent events through the issuance date of the consolidated financial statements. We are not aware of any significant events, that occurred subsequent to the balance sheet date but prior to the filing of this Quarterly Report on Form 10-Q that would have a material impact on our consolidated financial statements.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of our financial condition and results of operations should be read together with our consolidated financial statements and related notes included in Part I, Item 1 of this report, and with our consolidated financial statements and related notes, and Management's Discussion and Analysis of Financial Condition and Results of Operations, included in our Annual Report on Form 10-K for the year ended December 31, 2013, which was filed with the Securities and Exchange Commission on March 6, 2014. This discussion contains forward-looking statements that involve risks and uncertainties. Words such as "expects," "anticipated," "will," "may," "goals," "plans," "believes," "estimates," variations of these words, and similar expressions are intended to identify these forward-looking statements. As a result of many factors, such as those set forth under the section entitled "Risk Factors" in Part II, Item 1A and elsewhere in this report, our actual results may differ materially from those anticipated in these forward-looking statements. Readers are cautioned that these forward-looking statements are only predictions based upon assumptions made that we believed to be reasonable at the time, and are subject to risks and uncertainties. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. Except as required by law, we undertake no obligation to revise or update publicly any forward-looking statements.

Overview

NovaBay Pharmaceuticals is a clinical-stage biopharmaceutical company focused on addressing the unmet therapeutic needs of the global, topical anti-infective market with its two distinct categories of products: Aganocides[®] and NeutroPhase[®].

Aganocide[®] Compounds

NovaBay's first-in-class Aganocid[®] compounds, led by auriclosene (NVC-422), are patented, synthetic molecules with a broad spectrum of activity against bacteria, viruses and fungi. Mimicking the mechanism of action that human white blood cells use against infections, Aganocides possess a reduced likelihood that bacteria or viruses will be able to develop resistance, which is critical for advanced anti-infectives. In recognition of NVC-422 first-in-class chemical structure and therapeutic characteristics, in February 2012, The World Health Organization (WHO) approved *auriclosene* as the new International Non-Proprietary Name (INN) for NVC-422. Having demonstrated therapeutic proof-of-concept, these compounds are well suited to treat and prevent a wide range of local, non-systemic infections. NovaBay is currently focusing auriclosene into three large therapeutic markets:

Urology - Statistically-significant and clinically-meaningful results from a Phase 2 clinical study of Auriclosene Irrigation Solution to reduce urinary catheter blockage and encrustation were announced in September 2013. Study

CL1001 achieved the study's primary endpoints and showed clear benefits for patients with long-term indwelling catheters. Based on these study results, NovaBay is in discussions with the FDA to design the protocol to be used in the next UCBE trial that is expected to begin in the second half of 2014.

Ophthalmology - NovaBay is developing an eye drop formulation of auriclosene for treating adenoviral conjunctivitis, for which there is currently no approved treatment. Enrollment in the global clinical trial for auriclosene in conjunctivitis was completed in March 2014. NovaBay is expecting top line data from the clinical trial in August 2014. NovaBay also initiated a proof-of-concept study for bacterial conjunctivitis in the second quarter of 2013 with the same auriclosene formulation.

Dermatology - Partnered with Galderma, a leading dermatology company, we are developing a gel formulation of auriclosene for treating impetigo, a highly contagious skin infection. In November 2013, NovaBay announced that the auriclosene Phase 2 clinical study of impetigo had been completed. While the study showed that auriclosene is safe and well tolerated, it did not meet its primary clinical endpoint. Knowledge gained from two previous impetigo studies is expected to lead to the use of an optimized formulation of auriclosene for an upcoming pilot study. We are planning the upcoming study, which is expected to cost approximately \$2 million. Based on the results of this Phase 2 study NovaBay and Galderma will determine the next steps in the development of auriclosene for this indication.

NovaBay Pure Hypochlorous Solution Family of Products

The NovaBay Pure Hypochlorous Solution Family of products includes NeutroPhase for wound care, as well as two new recently introduced products: i-Lid Cleanser for the eye care market and CelleRx for the aesthetic dermatology market.

NovaBay developed NeutroPhase, a distinct formulation containing hypochlorous acid. NeutroPhase is an FDA 510(k)-cleared Advanced Skin and Wound Cleanser. NeutroPhase is a patented NovaBay Pure Hypochlorous Solution which has the potential to be the best suited product on the market to treat the six-million patients in the U.S. who suffer from chronic non-healing wounds, such as pressure, venous stasis and diabetic ulcers.

NovaBay has begun securing commercial partnerships for NeutroPhase. In January 2012, NovaBay announced it had entered into an exclusive distribution agreement for China with Pioneer Pharma Holdings Limited. (HK: 1345) (“Pioneer”), a Shanghai-based company that markets high-end pharmaceutical products in the Asia Pacific region. In December 2013, Pioneer invested \$5.7 million in NovaBay. Previously we had expanded the distribution agreement with Pioneer to include territories outside of China. The expanded agreement with Pioneer also includes licensing rights to the two new products variations, CelleRx™ and i-Lid™ Cleanser. The expanded partnership agreement covers the commercialization and distribution of these products in China and 11 countries in Southeast Asia.

In 2013, NovaBay entered into a distribution agreement with Shin Poong Pharmaceuticals, Co., Ltd. (Shin Poong), a South Korean based company to market NeutroPhase in South Korea. In 2013 NovaBay entered into a distribution agreement with Principal Business Enterprises Inc. (PBE) of Bowling Green, Ohio to market its NeutroPhase product in the US market. NovaBay expects to announce additional distribution agreements in select geographic markets around the world during 2014.

In November 2013, we announced the publication of a scientific paper by Dr. John R. Crew of Seton Medical Center, Daly City California, describing the first use of adjunctive NeutroPhase® irrigation therapy in conjunction with Negative Pressure Wound Therapy (NPWT) to successfully manage the severely-infected wound in the arm of a patient with a life-threatening ‘flesh-eating’ infection.

NovaBay has developed additional formulations such as i-Lid™ Cleanser (for use in ophthalmological applications) and CelleRx™ (for use in aesthetic dermatology). We introduced both products into selected markets in April 2014.

To date, we have generated very little revenue from product sales, and we have financed our operations and internal growth primarily through the sale of our capital stock, and the fees received from partners. As we are a development stage company, we have incurred significant losses since commencement of our operations in July 2002, since we have devoted substantially all of our resources to research and development. As of June 30, 2014, we had an accumulated deficit of \$62.9 million. This deficit resulted from research and development expenses as well as general and administrative expenses. We expect to incur net losses over the next several years as we continue our clinical and research and development activities and as we apply for patents and regulatory approvals.

Recent Events

In January 2014, we announced that we had appointed Mark M. Sieczkarek and Dr. Massimo Radaelli to our Board of Directors.

In March 2014, we announced an underwritten public offering of an aggregate of 5,600,000 shares of NovaBay's common stock, and 18-month warrants to purchase up to an aggregate of 1,400,000 shares of common stock at a combined price to the public of \$1.20 for aggregate gross proceeds of \$6,720,000. The warrants were exercisable immediately upon issuance, have an 18-month term and an exercise price of \$1.56 per share.

In April 2014, we announced that we are introducing a new eye care product, i-Lid™ Cleanser. The product was introduced at the American Society of Cataract and Refractive Surgery (booth number 583) in Boston in late April 2014. Already cleared by the FDA through its 510(k) process, our Advanced i-Lid Cleanser can help patients with irritation of their eyelids by cleaning their lids and lashes and removing debris and microorganisms that often lead to vision problems.

In April 2014, we announced that Dr. John R. Crew, Medical Director of the Advanced Wound Care Center at Seton Medical Center in Daly City, California, presented a poster at the Spring Symposium on Advanced Wound Care. Dr. Crew described how he successfully used NeutroPhase as an adjunct therapy to irrigate the wounds of four patients with life-threatening necrotizing fasciitis (also known as flesh-eating infections), in conjunction with an irrigation technique involving Negative Pressure Wound Therapy (NPWT). All of the patients healed completely and none lost any limbs.

In May 2014, we announced the completion of patient enrollment in our global Phase 2b viral conjunctivitis trial, BAYnovation. The trial is investigating our Auriclosene (NVC-422) Ophthalmic Solution as a treatment for adenoviral conjunctivitis, a highly contagious, potentially sight-impairing form of “pink eye.”

In May 2014, we announced that Todd A. Linsenmeyer, M.D., Director of Urology, Kessler Institute for Rehabilitation, presented the results from our phase 2 clinical trial of our Auriclosene Irrigation Solution (AIS) at the annual meeting of the American Urological Association.

In June 2014, we announced that Christine Sindt OD, Clinical Associate Professor of Ophthalmology and Visual Sciences at University of Iowa’s Carver College of Medicine, discussed our i-Lid Cleanser at the annual Optometry’s Meeting of the American Optometric Association in Philadelphia, PA.

In July 2014, our Chief Executive Officer, Dr. Ron Najafi published a letter to our shareholders providing updates on each of clinical programs and commercial products. The letter states that we expect to announce top line data from our BAYnovation trial in mid-August.

In July 2014, we also announced that we will initiate a major marketing campaign and commercialization effort for the company’s new product, i-Lid Cleanser. The product launch will be led by Glenn Moro, NovaBay’s new Vice President of Sales and Marketing.

Critical Accounting Policies and Estimates

Our consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States for interim reporting. The preparation of these consolidated financial statements requires us to make estimates, assumptions and judgments that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements as well as the reported revenues and expenses during the reporting periods. In preparing these consolidated financial statements, management has made its best

estimates and judgments of certain amounts included in the financial statements giving due consideration to materiality. On an ongoing basis, we evaluate our estimates and judgments related to revenue recognition, research and development costs, patent costs, stock-based compensation, income taxes and other contingencies. We base our estimates on historical experience and on various other factors that we believe are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Our significant accounting policies are more fully described in Note 2 of the Notes to Consolidated Financial Statements (unaudited), included in Part I, Item 1 of this report, and are also described in Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2013. We have not materially changed these policies from those reported in our Annual Report on Form 10-K for the year ended December 31, 2013.

Recent Accounting Pronouncements

See Note 2 to the accompanying unaudited consolidated financial statements included in Part I, Item 1 of this quarterly report on Form 10-Q for information on recent accounting pronouncements.

Results of Operations

Comparison of the Three and Six Months Ended June 30, 2014 and 2013

License, Collaboration, Distribution and Product Revenue

Total license, collaboration, distribution and product revenue was \$122,000 for the three months ended June 30, 2014, compared to \$848,000 for the three months ended June 30, 2013. Total license, collaboration, distribution and product revenue was \$411,000 for the six months ended June 30, 2014, compared to \$1.9 million for the six months ended June 30, 2013. The decreases were related to the full amortization of the upfront payments from Galderma in 2013 and the end of the FTE funding period of the same contract.

License, collaboration, distribution and product revenue is due to several different agreements entered into by NovaBay. Those agreements are:

- a license and collaboration agreement entered into with Galderma in 2009;
- a distribution agreement covering China entered into with Pioneer Pharma in Jan 2012;
- a second distribution agreement with Pioneer Pharma covering South East Asia along with a stock purchase agreement;
- a feasibility and option agreement with Virbac, a global animal health company, expanded to a collaboration in 2013;
- and
 - various distribution agreement entered into for the distribution of NeutroPhase.

The decrease in license, collaboration, distribution and sales revenue was related in the full amortization of the up-front fees from Galderma paid in 2013 and the end of the FTE funding period of that same contract, which was offset to some degree by increases in sales of NeutroPhase products.

Research and Development

Total research and development expenses decreased by 24% to \$2.2 million for the three months ended June 30, 2014, compared to \$2.9 million the three months ended June 30, 2013. Total research and development expenses decreased by 19% to \$4.8 million for the six months ended June 30, 2014, compared to \$5.9 million the six months ended June

30, 2013. The changes over the periods relate to the decrease in clinical activities as we near completion on our BAYnovation trial for viral conjunctivitis and BACTOvation trial for bacterial conjunctivitis. In addition, we completed our urology (UCBE) trial in the second half of 2013.

We expect to incur increasing research and development expenses throughout 2014 and in subsequent years as we continue to develop product candidates, both independently and in collaboration with our commercial partners. In particular, we expect to incur substantially increased clinical expenses and ongoing manufacturing expenses in connection with our dermatology, ophthalmology and urology programs.

General and Administrative

General and administrative expenses decreased by 20% to \$1.7 million for the three months ended June 30, 2014, from \$2.0 million for the three months ended June 30, 2013. General and administrative expenses decreased by 7% to \$3.4 million for the six months ended June 30, 2014, from \$3.6 million for the six months ended June 30, 2013. The decreases are primarily due to warrant modification expense of \$0.2 million for a warrant issued under our equity purchase agreement with Pioneer Pharma Co. Ltd., recorded in the three months ended June 30, 2013 and lower travel and entertainment expenses in 2014.

We expect to incur increasing general and administrative expenses throughout 2014 and in subsequent years as we support our launch of NovaBay Pure Hypochlorous Solution Family of products.

Non-Cash Gain (Loss) on Changes in Fair Value of Warrants

The non-cash gain (loss) on changes in fair value of warrants relates to the fair value adjustment to the warrants issued with our July 2011 registered direct offering of common stock and warrants. This balance will fluctuate with the price of our stock.

Other Income (Expense), Net

Other income (expense), net changes were primarily attributable to fluctuation in the gains and losses on our investments and losses on disposal of property.

We expect that other income (expense), net will fluctuate based on our cash balances and the fluctuation in the returns on our investments.

Liquidity and Capital Resources

As of June 30, 2014, we had cash, cash equivalents, and short-term investments of \$11.6 million, compared to \$13.1 million at December 31, 2013. We have incurred cumulative net losses of \$62.9 million since inception through June 30, 2014. We do not expect to generate significant revenue from product candidates for several years. Since inception, we have funded our operations primarily through the sales of our stock and warrants and funds received under our collaboration agreements. Cash received from our collaboration partners have totaled \$65.3 million through June 30, 2014. Since December 31, 2013 we have raised net proceeds of \$473,000 related to sales of our stock through the ATM Agreement set up in 2013. In March 2014, we closed an additional financing in which we raised a total of \$6.7 million, or approximately \$6.0 million in net cash proceeds after deducting underwriting commissions of \$470,000 and other offering costs of \$211,000. We continue to believe the capital generated through these sources is sufficient to fund our planned operations over the next twelve months. Our capital requirements going forward will depend on numerous factors including:

- the number and characteristics of product development programs we pursue and the pace of each program;
- the scope, rate of progress, results and costs of clinical trials;
- the time, cost and outcome involved in seeking regulatory approvals;
- our ability to establish and maintain strategic collaborations or partnerships for clinical trials, manufacturing and marketing of our product candidates; and
- the cost of establishing clinical and commercial supplies of our product candidates and any products that we may develop.

Cash Used in Operating Activities

For the six months ended June 30, 2014, cash used in operating activities of \$8.2 million was primarily attributable to our research and development and general administrative expenses of operating the company.

Cash Used in Investing Activities

For the six months ended June 30, 2014, cash used in investing activities of \$1.2 million was primarily attributable to the net effect of purchases of short-term investments and sales and maturities.

Cash Provided by Financing Activities

Net cash provided by financing activities of \$6.6 million for the six months ended June 30, 2014, was primarily attributable to proceeds from sales our common stock under our ATM agreement and the sale of common stock and warrants in our March financing.

Net Operating Losses and Tax Credit Carryforwards

As of December 31, 2013, we had net operating loss carryforwards for federal and state income tax purposes of \$48.7 million and \$50.5 million, respectively. If not utilized, the federal and state net operating loss carryforwards will begin expiring at various dates between 2015 and 2033. As of December 31, 2013, we also had tax credit carryforwards for federal income tax purposes of \$343,000.

Current federal and California tax laws include substantial restrictions on the utilization of net operating loss carryforwards in the event of an ownership change of a corporation. Accordingly, our ability to utilize net operating loss carryforwards may be limited as a result of such ownership changes. Such a limitation could result in the expiration of carryforwards before they are utilized.

Inflation

We do not believe that inflation has had a material impact on our business and operating results during the periods presented, and we do not expect it to have a material impact in the near future. There can be no assurances, however, that our business will not be affected by inflation.

Off-Balance Sheet Arrangements

We have no off-balance sheet arrangements.

Contractual Obligations

Our commitments at June 30, 2014 consist of an operating lease. The operating lease consists of payments relating to the lease for various laboratory and office space in one office building in Emeryville, California. This lease expires on October 31, 2020, and the total commitment as of June 30, 2014 is \$4.2 million due over the lease term, compared to \$4.5 million as of December 31, 2013.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our market risk consists principally of interest rate risk on our cash, cash equivalents, and short-term investments. Our exposure to market risk is limited primarily to interest income sensitivity, which is affected by changes in interest rates, particularly because the majority of our investments are in short-term debt securities.

Our investment policy restricts our investments to high-quality investments and limits the amounts invested with any one issuer, industry, or geographic area. The goals of our investment policy are as follows: preservation of capital; assurance of liquidity needs; best available return on invested capital; and minimization of capital taxation. Some of the securities in which we invest may be subject to market risk. This means that a change in prevailing interest rates may cause the principal amount of the investment to fluctuate. For example, if we hold a security that was issued with an interest rate fixed at the then-prevailing rate and the prevailing interest rate later rises, the principal amount of our investment will probably decline. To minimize this risk, in accordance with our investment policy, we maintain our cash and cash equivalents in short-term marketable securities, including money market mutual funds, Treasury bills, Treasury notes, commercial paper, and corporate and municipal bonds. The risk associated with fluctuating interest rates is limited to our investment portfolio. Due to the short term nature of our investment portfolio, we believe we have minimal interest rate risk arising from our investments. As of June 30, 2014, and December 31, 2013, a 10% change in interest rates would have had an immaterial effect on the value of our short-term marketable securities. We do not use derivative financial instruments in our investment portfolio. We do not hold any instruments for trading purposes.

To date, we have operated exclusively in the United States and have not had any material exposure to foreign currency rate fluctuations.

ITEM 4. CONTROLS AND PROCEDURES

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures pursuant to Rule 13a-15 and 15d-15 of the Securities Exchange Act of 1934, as amended (the “Exchange Act”). Based upon that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective at the reasonable assurance level to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms and were effective in ensuring that information required to be disclosed by us in the reports that we file or submit under the Exchange Act was accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Assessing the costs and benefits of such controls and procedures necessarily involves the exercise of judgment by management. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected.

Changes in Internal Control Over Financial Reporting

There was no change in our internal control over financial reporting during the quarter ended June 30, 2014, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1A. RISK FACTORS

Our business is subject to a number of risks, the most important of which are discussed below. You should consider carefully the following risks in addition to the other information contained in this report and our other filings with the SEC, before deciding to buy, sell or hold our common stock. The risks and uncertainties described below are not the only ones facing our company. Additional risks and uncertainties not presently known to us or that we currently believe are not important may also impair our business operations. If any of the following risks actually occur, our business, financial condition or results of operations could be materially adversely affected, the value of our common stock could decline and you may lose all or part of your investment. These risks have not changed substantively from the risks described under Part I, Item 1A “Risk Factors” included in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 6, 2014, except for those risk factors marked with an asterisk ().*

Risks Relating to Our Business

We may be unable to raise additional capital on acceptable terms in the future which may in turn limit our ability to develop and commercialize products and technologies. *

As of June 30, 2014, we had cash, cash equivalents and short term investments of \$11.6 million, which we believe is sufficient to fund our operations through at least the next twelve months at our current level of spending. While we have reduced our staff levels and reduced both our research and general expenditures, we expect our capital outlays and operating expenditures to increase over at least the next several years as we expand our clinical and regulatory activities as well as expand our sales activities with respect to i-Lid Cleanser. Conducting clinical trials is very expensive, and we expect that we will need to raise additional capital, through future private or public equity offerings, strategic alliances or debt financing, before we achieve commercialization of auriclosene, our primary Aganocide compound, or any of any of our other Aganocide compounds. In addition, we may require even more significant capital outlays and operating expenditures if we do not continue to partner with third parties to develop and commercialize our products.

Our future capital requirements will depend on many factors, including:

the extent to which we receive milestone payments or other funding from corporate partners, if any;
the scope, rate of progress and cost of our pre-clinical studies and clinical trials and other research and development activities;

future clinical trial results;
the terms and timing of any collaborative, licensing and other arrangements that we may establish;
the cost and timing of regulatory approvals;
the cost of establishing clinical and commercial supplies of our product candidates and any products that we may develop;
the effect of competing technological and market developments;
the costs associated with marketing and selling i-Lid Cleanser;
the cost of filing, prosecuting, defending and enforcing any patent claims and other intellectual property rights; and
the extent to which we acquire or invest in businesses, products and technologies, although we currently have no commitments or agreements relating to any of these types of transactions.

We do not currently have any commitments for future external funding. Additional financing may not be available on favorable terms, or at all. Our ability to obtain additional financing may be negatively affected by the recent volatility in the financial markets, as well as the general downturn in the economy and decreased consumer confidence. Even if we succeed in selling additional securities to raise funds, our existing stockholders' ownership percentage would be diluted and new investors may demand rights, preferences or privileges senior to those of existing stockholders. If we raise additional capital through strategic alliance and licensing arrangements, we may have to trade our rights to our technology, intellectual property or products to others on terms that may not be favorable to us. If we raise additional capital through debt financing, the financing may involve covenants that restrict our business activities.

In addition, it is often the case that the cost of pharmaceutical development can be significantly greater than initially anticipated. This may be due to any of a large number of possible reasons, some of which could have been anticipated, while others may be caused by unpredictable circumstances. A significant increase in our costs would cause the amount of financing that would be required to enable us to achieve our goals to be likewise increased.

If we determine that we need to raise additional funds and we are not successful in doing so, we may be unable to complete the clinical development of some or all of our product candidates or to seek or obtain FDA approval of our product candidates. Such events could force us to discontinue product development, enter into a relationship with a strategic partner earlier than currently intended, reduce sales and marketing efforts or forego attractive business opportunities.

We are an early stage company with a history of losses and expect that we will incur net losses in the future, and that we may never achieve or maintain sustained profitability. *

We have incurred net losses each year since our inception through June 30, 2014, with the exception of 2009. For the years ended December 31, 2013, 2012 and 2011, we had net losses of approximately \$ 16.0 million, \$7.0 million and \$5.1 million, respectively. For the six months ended June 30, 2014 we have net losses of approximately \$6.5 million. We were able to record a profit in 2009 due to our receipt of a \$3.75 million milestone payment under our agreement with Galderma; however, there is no assurance that we will receive any additional large milestone payments under this agreement and, as a result, may not be able to achieve or maintain profitability in the future. Through June 30, 2014, we had an accumulated deficit of approximately \$62.9 million. We have been, and expect to remain for the foreseeable future, engaged mostly in research and development as we proceed through clinical trials. We have incurred substantial research and development expenses, which were approximately \$12.5 million, \$9.3 million and \$9.9 million for the years ended December 31, 2013, 2012 and 2011, respectively and \$4.8 million for the six months ended June 30, 2014. We expect to continue to make, for at least the next several years, significant expenditures for the development of products that incorporate our Aganocide compounds, as well as continued research into the biological activities of our Aganocide compounds, which expenditures are accounted for as research and development expenses. We also expect to incur substantial marketing and sales expenses as we have just recently launched i-Lid Cleanser. We expect to incur substantial losses for the foreseeable future, and we may never achieve or maintain sustained profitability. We anticipate that our expenses related to our clinical trials and regulatory activities will increase substantially in the foreseeable future as we:

conduct pre-clinical studies and clinical trials for our product candidates in different indications;
develop, formulate, manufacture and commercialize our product candidates either independently or with partners;
pursue, acquire or in-license additional compounds, products or technologies, or expand the use of our technology;
maintain, defend and expand the scope of our intellectual property; and
hire additional qualified personnel.

We will need to generate significant revenues to achieve and maintain profitability. If we cannot successfully develop, obtain regulatory approval for and commercialize auriclosene, either independently or with partners, we will not be able to generate such revenues or achieve or maintain profitability in the future. Our failure to achieve and subsequently maintain profitability could have a material adverse impact on the market price of our common stock.

We have limited data on the use of some of our products in humans and will need to perform costly and time consuming clinical trials to bring our products to market.

Much of the data that we have on our auriclosene compound is from in-vitro (laboratory) studies, in-vivo animal studies, Phase 1 human safety studies, or some small-scale Phase 2a or other exploratory clinical studies. We will need to conduct additional Phase 2 and Phase 3 human clinical trials to confirm such results in larger patient populations to obtain approval from the FDA of our Aganocide drug product candidates. Often, positive in-vitro, in-vivo animal studies, or early human clinical trials are not followed by positive results in later clinical trials, and we may not be able to demonstrate that our Aganocide product candidates are safe and effective for indicated uses in humans or that they are active against antibiotic resistant microbes, do not allow pathogens to develop resistance or are active against bacteria in biofilm. In addition, for each indication, we estimate that it will take between three and five years to conduct the necessary clinical trials.

If we are unable to develop and obtain regulatory approval for our Aganocide compounds, we may never generate product revenues.

To date, our revenues have been derived mainly from research and development collaboration and license agreements. We have not yet generated any substantial revenue from i-Lid Cleanser and CelleRx. We have generated only limited revenues from sales of NeutroPhase, and we cannot guarantee that we will ever be able to generate substantial revenue from i-Lid Cleanser, CelleRx or NeutroPhase. Our Aganocide compounds are still in development and we will not be able to generate commercial revenue from the sale of these product candidates until we have received regulatory approval for them. Satisfaction of all regulatory requirements applicable to our product candidates typically takes many years, is dependent upon the type, complexity, novelty and classification of the product candidates, and requires the expenditure of substantial resources for research and development and testing. We must demonstrate that our product candidates satisfy rigorous standards of safety and efficacy before we can submit for and gain approval from the FDA and regulatory authorities in other countries. In addition, to compete effectively, our products will need to be easy to use, cost-effective and economical to manufacture on a commercial scale. We may not achieve any of these objectives. We cannot be certain that the clinical development of any of our current product candidates or any other product that we may develop in the future will be successful, that they will receive the regulatory approvals required to commercialize them, or that any of our other in-licensing efforts or pre-clinical testing will yield a product suitable for entry into clinical trials. Our commercial revenues from sales of Aganocide products will be derived from sales of products that may not be commercially available for at least the next several years.

We have three commercialized products, i-Lid Cleanser, CelleRx and NeutroPhase, and if these products do not gain market acceptance, our business will suffer. *

A number of factors may affect the market acceptance of i-Lid Cleanser, CelleRx and NeutroPhase, or any other products we develop or acquire, including, among others:

- the price of our products relative to other products for the same or similar treatments;
- the perception by patients, physicians and other members of the health care community of the effectiveness and safety of our products for their indicated applications and treatments;
- our ability to find the right distributor; and
- the effectiveness of the sales and marketing efforts of our distributor.

If our products do not gain market acceptance, we may not be able to support funding of our future operations, including developing, testing and obtaining regulatory approval for new product candidates, which would cause our business to suffer.

We have limited experience in developing drugs and medical devices, and we may be unable to commercialize some of the products we develop.

Development and commercialization of drugs and medical devices involves a lengthy and complex process. We have limited experience in developing products and have only one commercialized product in the market. In addition, no one has ever developed or commercialized a product based on our Aganocide compounds, and we cannot assure you that it is possible to develop, obtain regulatory approval for or commercialize any products based on these compounds or that we will be successful in doing so.

Before we can develop and commercialize any new products, we will need to expend significant resources to:

- undertake and complete clinical trials to demonstrate the efficacy and safety of our product candidates;
- maintain and expand our intellectual property rights;
- obtain marketing and other approvals from the FDA and other regulatory agencies; and
- select collaborative partners with suitable manufacturing and commercial capabilities.

The process of developing new products takes several years. Our product development efforts may fail for many reasons, including:

- the failure of our product candidates to demonstrate safety and efficacy;
- the high cost of clinical trials and our lack of financial and other resources; and
- our inability to partner with firms with sufficient resources to assist us in conducting clinical trials.

Success in early clinical trials often is not replicated in later studies, and few research and development projects result in commercial products. At any point, we may abandon development of a product candidate or we may be required to expend considerable resources repeating clinical trials, which would eliminate or adversely impact the timing for revenues from those product candidates. If a clinical study fails to demonstrate the safety and effectiveness of our product candidates, we may abandon the development of the product or product feature that was the subject of the clinical trial, which could harm our business.

Even if we develop products for commercial use, these products may not be accepted by the medical and pharmaceutical marketplaces or be capable of being offered at prices that will enable us to become profitable. We cannot assure you that our products will be approved by regulatory authorities or ultimately prove to be useful for commercial markets, meet applicable regulatory standards, or be successfully marketed.

Our current collaboration with Galderma may fail, resulting in a decrease in funding and inhibition of our ability to continue developing products.

We have entered into an agreement with Galderma S.A. to develop and commercialize our Aganocide compounds, which covers acne and impetigo and potentially other major dermatological conditions, excluding onychomycosis (nail fungus) and orphan drug indications. Our collaboration with Galderma is our only major collaboration in the human field, and so unless and until we enter into additional collaborations or are able to market products on our own, we will be dependent on Galderma for the majority of our collaboration revenues.

In November 2013, we and Galderma announced that the auriclosene Phase 2 clinical study of impetigo had been completed, and that while the study showed that auriclosene is safe and well tolerated, it did not meet its primary clinical endpoint. While the collaboration is still intact, we cannot assure you that future clinical trials will be successful, or that we will receive the full amount of any remaining research funding, milestone payments or royalties, or that any commercially valuable intellectual property will be created, from this arrangement. If Galderma were to breach or terminate its agreement with us or otherwise fail to conduct its collaborative activities successfully and in a timely manner, the research contemplated by our collaboration with them could be delayed or terminated and our costs of performing studies may increase.

We are funding the development of our Aganocide compounds for application in connection with the eye and urinary tract, which we may not be able to do unless we are able to enter into a new collaboration with another collaboration partner.

As we continue the development of auriclesene (NVC-422) for application in connection with ophthalmology, urology and dermatology, we have to fund such development unless we are able to enter into a collaboration with a collaboration partner, which we may not be able to do, especially because we previously had a collaboration and license agreement with Alcon, which we and Alcon terminated in June 2011. If we are not able to enter into a new collaboration with another collaboration partner and we continue the development of auriclesene (NVC-422) for any application, we will need to rely on our own funds, and any additional funds we may raise. If we are not able to enter into a new collaboration with another collaboration partner or are not able to raise additional funds, we may not be able to develop auriclesene (NVC-422) for these applications.

A key part of our business strategy is to establish collaborative relationships to commercialize and fund development of our product candidates. We may not succeed in establishing and maintaining collaborative relationships, which may significantly limit our ability to develop and commercialize our products successfully, if at all.

A key part of our business strategy is to establish collaborative relationships to commercialize and fund development of our product candidates. We may not be able to negotiate additional collaborations on acceptable terms, if at all, and if we do enter into collaborations, these collaborations may not be successful. Our current and future success depends in part on our ability to enter into successful collaboration arrangements and maintain the collaboration arrangement we currently have with Galderma. The process of establishing and maintaining collaborative relationships is difficult, time-consuming and involves significant uncertainty, including:

our partners may seek to renegotiate or terminate their relationships with us due to unsatisfactory clinical results, a change in business strategy, a change of control or other reasons;

our shortage of capital resources may impact a willingness on the part of potential companies to collaborate with us; our contracts for collaborative arrangements may be terminable for convenience on written notice and may otherwise expire or terminate, and we may not have alternative funding available; our partners may choose to pursue alternative technologies, including those of our competitors; we may have disputes with a partner that could lead to litigation or arbitration; we do not have day-to-day control over the activities of our partners and have limited control over their decisions; our ability to receive milestones and royalties from our partners depends upon the abilities of our partners to establish the safety and efficacy of our drug candidates, obtain regulatory approvals and achieve market acceptance of products developed from our drug candidates; we or our partners may fail to properly initiate, maintain or defend our intellectual property rights, where applicable, or a party may utilize our proprietary information in such a way as to invite litigation that could jeopardize or potentially invalidate our proprietary information or expose us to potential liability; our partners may not devote sufficient capital or resources towards our product candidates; and our partners may not comply with applicable government regulatory requirements.

If we are unable to establish and maintain collaborative relationships on acceptable terms or to successfully transition terminated collaborative agreements, we may have to delay or discontinue further development of one or more of our product candidates, undertake development and commercialization activities at our own expense or find alternative sources of capital. Consequently, if we are unable to enter into, maintain or extend successful collaborations, our business may be harmed.

Our long-term success depends upon the successful development and commercialization of products other than auroclosine from our research and development activities.

Our long-term viability and growth will depend upon the successful development and commercialization of products other than auroclosine from our research and development activities. Product development and commercialization is very expensive and involves a high degree of risk. Only a small number of research and development programs result in the commercialization of a product. Success in early stage clinical trials or preclinical work does not ensure that later stage or larger scale clinical trials will be successful. Even if later stage clinical trials are successful, the risk remains that unexpected concerns may arise from additional data or analysis or that obstacles may arise or issues may be identified in connection with review of clinical data with regulatory authorities or that regulatory authorities may disagree with our view of the data or require additional data or information or additional studies.

Conducting clinical trials is a complex, time-consuming and expensive process. Our ability to complete our clinical trials in a timely fashion depends in large part on a number of key factors including protocol design, regulatory and institutional review board approval, the rate of patient enrollment in clinical trials, and compliance with extensive current good clinical practice requirements. We are in many cases using the services of third-party contract clinical trial providers. If we fail to adequately manage the design, execution and regulatory aspects of our clinical trials, our studies and ultimately our regulatory approvals may be delayed or we may fail to gain approval for our product candidates altogether.

If we do not successfully execute our growth initiatives through the acquisition, partnering and in-licensing of products, technologies or companies, our future performance could be adversely affected.

In addition to our internal development projects, we anticipate growing through external growth opportunities, which include the acquisition, partnering and in-licensing of products, technologies and companies or the entry into strategic alliances and collaborations. If we are unable to complete or manage these external growth opportunities successfully, we may not be able to grow our business in the way that we currently expect. The availability of high quality opportunities is limited and we are not certain that we will be able to identify suitable candidates or complete transactions on terms that are acceptable to us. To pursue such opportunities, we may require significant additional financing, which may not be available to us on favorable terms, if at all. The availability of such financing is limited by the recent tightening of the global credit markets.

We may acquire other businesses or form joint ventures or in-license compounds that could disrupt our business, harm our operating results, dilute your ownership interest in us, or cause us to incur debt or significant expense.

As part of our business strategy, we may pursue acquisitions of complementary businesses and assets, and enter into technology or pharmaceutical compound licensing arrangements. We also may pursue strategic alliances that leverage our core technology and industry experience to enhance our ability to commercialize our product candidates and expand our product offerings or distribution. We have no experience with respect to acquiring other companies and limited experience with respect to the formation of commercial partnering agreements, strategic alliances, joint ventures or in-licensing of compounds. If we make any acquisitions, we may not be able to integrate these acquisitions successfully into our existing business, and we could assume unknown or contingent liabilities. If we in-license any additional compounds, we may fail to develop the product candidates, and spend significant resources before determining whether a compound we have in-licensed will produce revenues. Any future acquisitions or in-licensing by us also could result in significant write-offs or the incurrence of debt and contingent liabilities, any of which could harm our operating results. Integration of an acquired company also may require management resources that otherwise would be available for ongoing development of our existing business. We may not identify or complete these transactions in a timely manner, on a cost-effective basis, or at all, and we may not realize the anticipated benefits of any acquisition, technology license, strategic alliance or joint venture.

To finance any acquisitions, we may choose to issue shares of our common stock as consideration, which would dilute your interest in us. If the price of our common stock is low or volatile, we may not be able to acquire other companies for stock. Alternatively, it may be necessary for us to raise additional funds for acquisitions by incurring indebtedness. Additional funds may not be available on terms that are favorable to us, or at all.

We do not have our own manufacturing capacity, and we plan to rely on partnering arrangements or third-party manufacturers for the manufacture of our products and potential products.

We do not currently operate manufacturing facilities for clinical or commercial production of our product candidates. We have no experience in drug formulation or manufacturing, and we lack the resources and the capabilities to manufacture any of our product candidates on a clinical or commercial scale. As a result, we have partnered and expect to partner with third parties to manufacture our products or rely on contract manufacturers to supply, store and distribute product supplies for our clinical trials. Any performance failure on the part of our commercial partners or future manufacturers could delay clinical development or regulatory approval of our product candidates or commercialization of our products, producing additional losses and reducing or delaying product revenues.

Our products, if developed and commercialized, will require precise, high quality manufacturing. The failure to achieve and maintain high manufacturing standards, including the incidence of manufacturing errors, could result in patient injury or death, product recalls or withdrawals, delays or failures in product testing or delivery, cost overruns

or other problems that could seriously harm our business. Contract manufacturers and partners often encounter difficulties involving production yields, quality control and quality assurance, as well as shortages of qualified personnel. These manufacturers and partners are subject to ongoing periodic unannounced inspection by the FDA and corresponding state agencies to ensure strict compliance with current Good Manufacturing Practice and other applicable government regulations and corresponding foreign standards; however, we do not have control over third-party compliance with these regulations and standards. If any of our manufacturers or partners fails to maintain compliance, the production of our products could be interrupted, resulting in delays, additional costs and potentially lost revenues.

In addition, if the FDA or other regulatory agencies approve any of our product candidates for commercial sale, we will need to manufacture them in larger quantities. Significant scale-up of manufacturing will require validation studies, which the FDA must review and approve. If we are unable to successfully increase the manufacturing capacity for a product, the regulatory approval or commercial launch of any drugs may be delayed or there may be a shortage in supply and our business may be harmed as a result.

We depend on skilled and experienced personnel to operate our business effectively. If we are unable to recruit, hire and retain these employees, our ability to manage and expand our business will be harmed, which would impair our future revenue and profitability.

Our success largely depends on the skills, experience and efforts of our officers, especially our Chief Executive Officer, Chief Financial Officer, Senior Vice President, Ophthalmology, Senior Vice President, Advanced Wound Care, Senior Vice President of Product Development, Vice President of Medical Affairs, Senior Vice President, Business Development and other key employees. The efforts of each of these persons is critical to us as we continue to develop our technologies and as we attempt to transition into a company with commercial products. Any of our officers and other key employees may terminate their employment at any time. The loss of any of our senior management team members could weaken our management expertise and harm our ability to compete effectively, develop our technologies and implement our business strategies.

Our ability to retain our skilled labor force and our success in attracting and hiring new skilled employees will be a critical factor in determining whether we will be successful in the future. Our research and development programs and collaborations depend on our ability to attract and retain highly skilled scientists and technicians. We may not be able to attract or retain qualified scientists and technicians in the future due to the intense competition for qualified personnel among life science businesses, particularly in the San Francisco Bay Area. We also face competition from universities and public and private research institutions in recruiting and retaining highly qualified scientific personnel. We have also encountered difficulties in recruiting qualified personnel from outside the San Francisco Bay Area, due to the high housing costs in the area.

If we grow and fail to manage our growth effectively, we may be unable to execute our business plan.

Our future growth, if any, may cause a significant strain on our management, and our operational, financial and other resources. Our ability to grow and manage our growth effectively will require us to implement and improve our operational, financial and management information systems and to expand, train, manage and motivate our employees. These demands may require the hiring of additional management personnel and the development of additional expertise by management. Any increase in resources devoted to research and product development without a corresponding increase in our operational, financial and management information systems could have a material adverse effect on our business, financial condition, and results of operations.

If our facilities become inoperable, we will be unable to perform our research and development activities, fulfill the requirements under our collaboration agreement and continue developing products and, as a result, our business will be harmed.

We do not have redundant laboratory facilities. We perform substantially all of our research, development and testing in our laboratory located in Emeryville, California. Emeryville is situated on or near active earthquake fault lines. Our facility and the equipment we use to perform our research, development and testing would be costly to replace and could require substantial lead time to repair or replace. The facility may be harmed or rendered inoperable by natural or man-made disasters, including earthquakes, flooding and power outages, which may render it difficult or impossible for us to perform our research, development and testing for some period of time. The inability to perform our research and development activities may result in the loss of partners or harm our reputation, and we may be unable to regain those partnerships in the future. Our insurance coverage for damage to our property and the disruption of our business may not be sufficient to cover all of our potential losses, including the loss of time as well as the costs of lost opportunities, and may not continue to be available to us on acceptable terms, or at all.

Obtaining regulatory approval in the United States does not ensure we will obtain regulatory approval in other countries.

We will aim to obtain regulatory approval in the U.S. as well as in other countries. To obtain regulatory approval to market our proposed products outside of the U.S., we and any collaborator must comply with numerous and varying regulatory requirements in other countries regarding safety and efficacy. Approval procedures vary among countries and can involve additional product testing and additional administrative review periods. The time required to obtain approval in other countries might differ significantly from that required to obtain FDA approval. The regulatory approval process in other countries includes all of the risk associated with FDA approval as well as additional, presently unanticipated risks. Regulatory approval in one country does not ensure regulatory approval in another, but a failure or delay in obtaining regulatory approval in one country may negatively impact the regulatory process in others. Failure to obtain regulatory approval in other countries or any delay or setback in obtaining such approval could have the same adverse effects associated with regulatory approval in the U.S., including the risk that our product candidates may not be approved for all indications requested and that such approval may be subject to limitations on the indicated uses for which the product may be marketed. In addition, failure to comply with applicable regulatory requirements in other countries can result in, among other things, warning letters, fines, injunctions, civil penalties, recall or seizure of products, total or partial suspension of production, refusal of the government to renew marketing applications and criminal prosecution.

If we are unable to design, conduct and complete clinical trials successfully, we will not be able to obtain regulatory approval for our products.

To obtain FDA approval for our drug product candidates, we must submit to the FDA a New Drug Application, or NDA, demonstrating that the product candidate is safe and effective for its intended use. This demonstration requires significant research and animal tests, which are referred to as preclinical studies, as well as human tests, which are referred to as clinical trials.

Any clinical trials we conduct or that are conducted by our partners may not demonstrate the safety or efficacy of our product candidates. Success in pre-clinical testing and early clinical trials does not ensure that later clinical trials will be successful. Results of later clinical trials may not replicate the results of prior clinical trials and pre-clinical testing. Even if the results of one or more of our clinical trials are positive, we may have to commit substantial time and additional resources to conducting further preclinical studies or clinical trials before we can submit NDAs or obtain FDA approvals for our product candidates, and positive results of a clinical trial may not be replicated in subsequent trials.

Clinical trials are very expensive and difficult to design and implement. The clinical trial process is also time-consuming. Furthermore, if participating patients in clinical studies suffer drug-related adverse reactions during the course of such trials, or if we or the FDA believe that participating patients are being exposed to unacceptable health risks, we will have to suspend or terminate our clinical trials. Failure can occur at any stage of the trials, and we could encounter problems that cause us to abandon clinical trials or to repeat clinical studies. Further, because our product candidates are all in the same class of compounds, failure in one clinical trial may cause us or our partners to have to suspend or terminate other clinical trials. For example, if toxicity issues were to arise in one clinical trial, it could indicate that all of our product candidates have toxicity issues.

In addition, the completion of clinical trials can be delayed by numerous factors, including:

- delays in identifying and agreeing on acceptable terms with prospective clinical trial sites;
- slower than expected rates of patient recruitment and enrollment;
- increases in time required to complete monitoring of patients during or after participation in a trial; and
- unexpected need for additional patient-related data.

Any of these delays, if significant, could impact the timing, approval and commercialization of our product candidates and could significantly increase our overall costs of drug development.

Even if our clinical trials are completed as planned, their results may not support our expectations or intended marketing claims. The clinical trials process may fail to demonstrate that our products are safe and effective for indicated uses. Such failure would cause us to abandon a product candidate for some indications and could delay development of other product candidates.

Government agencies may establish usage guidelines that directly apply to our proposed products or change legislation or regulations to which we are subject.

Government usage guidelines typically address matters such as usage and dose, among other factors. Application of these guidelines could limit the use of products that we may develop. In addition there can be no assurance that government regulations applicable to our proposed products or the interpretation thereof will not change and thereby prevent the marketing of some or all of our products for a period of time or permanently. The FDA's policies may change and additional government regulations may be enacted that could prevent or delay regulatory approval of our product candidates. We cannot predict the likelihood, nature or extent of adverse government regulation that may arise from future legislation or administrative action, either in the U.S. or in other countries.

Our product candidates may be classified as a drug or a medical device, depending on the mechanism of action or indication for use and prior precedent, and a change in the classification may have an adverse impact on our revenues or our ability to obtain necessary regulatory approvals.

Several potential indications for our product candidates may be regulated under the medical device regulations of the FDA administered by the Center for Devices and Radiological Health and the same physical product may be regulated by the FDA's Center for Drug Evaluation and Research for another indication. Alternatively the products could be classified as combination products, in which case both the device and drug centers jointly review the submission. The products may be designated by the FDA as a drug or a medical device depending upon the regulatory definition of a drug and a device, their primary mode of action and the indications for use or product claims.

The use of i-Lid Cleanser, CelleRx and NeutroPhase as a solution for cleansing eye lids and lashes, skin and debriding wounds was cleared as a medical device. The determination as to whether a particular indication is considered a drug or a device is also based in part upon precedent. A reclassification by the FDA of an indication from a device to a drug indication during our development or post-commercialization for that indication could have a significant adverse impact due to the more rigorous and lengthy approval process required for drugs, as compared to medical devices. Such a change in classification can significantly increase development costs and prolong the time for development and approval, thus delaying revenues. A reclassification of an indication after approval from a drug to a device could result in a change in classification for reimbursement. In many cases, reimbursement for devices is significantly lower than for drugs and there could be a significant negative impact on our revenues.

We and our collaborators are and will be subject to ongoing FDA obligations and continued regulatory review, such as continued safety reporting requirements, and we and our collaborators may also be subject to additional FDA post-marketing obligations or new regulations, all of which may result in significant expense and which may limit our ability to commercialize our medical device and drug products and candidates.

Any regulatory approvals that we receive may also be subject to limitations on the indicated uses for which the product may be marketed or contain requirements for potentially costly post-marketing follow-up studies. The FDA may require us to commit to perform lengthy Phase IV post-approval studies, for which we would have to expend additional resources, which could have an adverse effect on our operating results and financial condition. In addition, if the FDA approves any of our drug product candidates, the labeling, packaging, adverse event reporting, storage, advertising, promotion and record keeping for the drug will be subject to extensive regulatory requirements. The subsequent discovery of previously unknown problems with the drugs, including adverse events of unanticipated severity or frequency, may result in restrictions on the marketing of the drugs or the withdrawal of the drugs from the market. If we are not able to maintain regulatory compliance, we may be subject to fines, suspension or withdrawal of regulatory approvals, product recalls, seizure of products, operating restrictions and criminal prosecution. Any of these events could prevent us from marketing any products we may develop and our business could suffer.

Conducting clinical trials of our product candidates may expose us to expensive liability claims, and we may not be able to maintain liability insurance on reasonable terms or at all.

The risk of clinical trial liability is inherent in the testing of pharmaceutical and medical device products. If we cannot successfully defend ourselves against any clinical trial claims, we may incur substantial liabilities or be required to limit or terminate testing of one or more of our product candidates. Our inability to obtain sufficient clinical trial insurance at an acceptable cost to protect us against potential clinical trial claims could prevent or inhibit the commercialization of our product candidates. Our current clinical trial insurance covers individual and aggregate claims up to \$5.0 million. This insurance may not cover all claims and we may not be able to obtain additional insurance coverage at a reasonable cost, if at all, in the future. In addition, if our agreements with any future corporate collaborators entitle us to indemnification against product liability losses and clinical trial liability, such indemnification may not be available or adequate should any claim arise.

If we use biological and hazardous materials in a manner that causes injury, we could be liable for damages. Compliance with environmental regulations can be expensive, and noncompliance with these regulations may result in adverse publicity and potentially significant monetary damages and fines.

Our activities currently require the controlled use of potentially harmful biological materials and other hazardous materials and chemicals and may in the future require the use of radioactive compounds. We cannot eliminate the risk of accidental contamination or injury to employees or third parties from the use, storage, handling or disposal of these materials. In the event of contamination or injury, we could be held liable for any resulting damages, and any liability could exceed our resources or any applicable insurance coverage we may have. Additionally, we are subject, on an ongoing basis, to U.S. federal, state and local laws and regulations governing the use, storage, handling and disposal of these materials and specified waste products. The cost of compliance with these laws and regulations might be significant and could negatively affect our operating results. In addition, if more stringent laws and regulations are adopted in the future, the costs of compliance with these new laws and regulations could be substantial or could impose significant changes in our testing and production process.

The pharmaceutical and biopharmaceutical industries are characterized by patent litigation and any litigation or claim against us may cause us to incur substantial costs, and could place a significant strain on our financial resources, divert the attention of management from our business and harm our reputation.

There has been substantial litigation in the pharmaceutical and biopharmaceutical industries with respect to the manufacture, use and sale of new products that are the subject of conflicting patent rights. For the most part, these lawsuits relate to the validity, enforceability and infringement of patents. Generic companies are encouraged to challenge the patents of pharmaceutical products in the United States because a successful challenger can obtain six months of exclusivity as a generic product under the Hatch-Waxman Act. We expect that we will rely upon patents, trade secrets, know-how, continuing technological innovations and licensing opportunities to develop and maintain our competitive position and we may initiate claims to defend our intellectual property rights as a result. Other parties may have issued patents or be issued patents that may prevent the sale of our products or know-how or require us to license such patents and pay significant fees or royalties to produce our products. In addition, future patents may issue to third parties which our technology may infringe. Because patent applications can take many years to issue, there may be applications now pending of which we are unaware that may later result in issued patents that our products may infringe.

Intellectual property litigation, regardless of outcome, is expensive and time-consuming, could divert management's attention from our business and have a material negative effect on our business, operating results or financial condition. If such a dispute were to be resolved against us, we may be required to pay substantial damages, including treble damages and attorney's fees if we were to be found to have willfully infringed a third party's patent, to the party claiming infringement, develop non-infringing technology, stop selling any products we develop, cease using technology that contains the allegedly infringing intellectual property or enter into royalty or license agreements that may not be available on acceptable or commercially practical terms, if at all. Our failure to develop non-infringing technologies or license the proprietary rights on a timely basis could harm our business. Modification of any products we develop or development of new products thereafter could require us to conduct additional clinical trials and to revise our filings with the FDA and other regulatory bodies, which would be time-consuming and expensive. In addition, parties making infringement claims may be able to obtain an injunction that would prevent us from selling any products we develop, which could harm our business.

We may be subject to damages resulting from claims that we or our employees have wrongfully used or disclosed alleged trade secrets of their former employers.

Some of our employees may have been previously employed at universities or other biotechnology or pharmaceutical companies, including our competitors or potential competitors. Although no claims against us are currently pending, we may be subject to claims that these employees or we have inadvertently or otherwise used or disclosed trade secrets or other proprietary information of their former employers. Litigation may be necessary to defend against these claims. Even if we are successful in defending against these claims, litigation could result in substantial costs and be a distraction to management. If we fail in defending such claims, in addition to paying money damages, we may lose valuable intellectual property rights or personnel. A loss of key research personnel or their work product could hamper

or prevent our ability to commercialize product candidates, which could severely harm our business.

If product liability lawsuits are brought against us, they could result in costly litigation and significant liabilities. *

The product candidates we are developing or attempting to develop will, in most cases, undergo extensive clinical testing and will require approval from the applicable regulatory authorities prior to sale. However, despite all reasonable efforts to ensure safety, it is possible that we or our collaborators will sell products, including i-Lid Cleanser and Neutrophase, which are defective, to which patients react in an unexpected manner, or which are alleged to have side effects. The manufacture and sale of such products may expose us to potential liability, and the industries in which our products are likely to be sold have been subject to significant product liability litigation. Any claims, with or without merit, could result in costly litigation, reduced sales, significant liabilities and diversion of our management's time and attention and could have a material adverse effect on our financial condition, business and results of operations.

If a product liability claim is brought against us, we may be required to pay legal and other expenses to defend the claim and, if the claim is successful, damage awards may not be covered, in whole or in part, by our insurance. We may not have sufficient capital resources to pay a judgment, in which case our creditors could levy against our assets. We may also be obligated to indemnify our collaborators and make payments to other parties with respect to product liability damages and claims. Defending any product liability claims, or indemnifying others against those claims, could require us to expend significant financial and managerial resources.

Failure to obtain sufficient quantities of products and substances necessary for research and development, pre-clinical studies, human clinical trials and product commercialization that are of acceptable quality at reasonable prices or at all could constrain our product development and have a material adverse effect on our business.

We have relied and will continue to rely on contract manufacturers for the foreseeable future to produce quantities of products and substances necessary for research and development, pre-clinical trials, human clinical trials and product commercialization. It will be important to us that such products and substances can be manufactured at a cost and in quantities necessary to make them commercially viable. At this point in time, we have not attempted to identify, and do not know whether there will be, any third party manufacturers which will be able to meet our needs with respect to timing, quantity and quality for commercial production. In addition, if we are unable to contract for a sufficient supply or required products and substances on acceptable terms, or if we should encounter delays or difficulties in our relationships with manufacturers, our research and development, pre-clinical and clinical testing would be delayed, thereby delaying the submission of product candidates for regulatory approval or the market introduction and subsequent sales of products. Any such delay may have a material adverse effect on our business, financial condition and results of operations.

Because our clinical development activities rely heavily on sensitive and personal information, an area which is highly regulated by privacy laws, we may not be able to generate, maintain or access essential patient samples or data to continue our research and development efforts in the future on reasonable terms and conditions, which may adversely affect our business.

As a result of our clinical development, we will have access to very sensitive data regarding the patients enrolled in our clinical trials. This data will contain information that is personal in nature. The maintenance of this data is subject to certain privacy-related laws, which impose upon us administrative and financial burdens, and litigation risks. For instance, the rules promulgated by the Department of Health and Human Services under the Health Insurance Portability and Accountability Act, or HIPAA, creates national standards to protect patients' medical records and other personal information in the U.S. These rules require that healthcare providers and other covered entities obtain written authorizations from patients prior to disclosing protected health care information of the patient to companies like NovaBay. If the patient fails to execute an authorization or the authorization fails to contain all required provisions, then we will not be allowed access to the patient's information and our research efforts can be substantially delayed. Furthermore, use of protected health information that is provided to us pursuant to a valid patient authorization is subject to the limits set forth in the authorization (i.e., for use in research and in submissions to regulatory authorities

for product approvals). As such, we are required to implement policies, procedures and reasonable and appropriate security measures to protect individually identifiable health information we receive from covered entities, and to ensure such information is used only as authorized by the patient. Any violations of these rules by us could subject us to civil and criminal penalties and adverse publicity, and could harm our ability to initiate and complete clinical studies required to support regulatory applications for our proposed products. In addition, HIPAA does not replace federal, state, or other laws that may grant individuals even greater privacy protections. We can provide no assurance that future legislation will not prevent us from generating or maintaining personal data or that patients will consent to the use of their personal information, either of which may prevent us from undertaking or publishing essential research. These burdens or risks may prove too great for us to reasonably bear, and may adversely affect our ability to function profitably in the future.

We may be subject to fines, penalties, injunctions and other sanctions if we are deemed to be promoting the use of our products for non-FDA-approved, or off-label, uses.

Our business and future growth depend on the development, use and ultimate sale of products that are subject to FDA regulation, clearance and approval. Under the U.S. Federal Food, Drug, and Cosmetic Act and other laws, we are prohibited from promoting our products for off-label uses. This means that we may not make claims about the safety or effectiveness of our products and may not proactively discuss or provide information on the use of our products, except as allowed by the FDA.

There is a risk that the FDA or other federal or state law enforcement authorities could determine that the nature and scope of our sales and marketing activities may constitute the promotion of our products for a non-FDA-approved use in violation of applicable law. We also face the risk that the FDA or other regulatory authorities might pursue enforcement based on past activities that we have discontinued or changed, including sales activities, arrangements with institutions and doctors, educational and training programs and other activities.

Government investigations concerning the promotion of off-label uses and related issues are typically expensive, disruptive and burdensome and generate negative publicity. If our promotional activities are found to be in violation of applicable law or if we agree to a settlement in connection with an enforcement action, we would likely face significant fines and penalties and would likely be required to substantially change our sales, promotion, grant and educational activities. In addition, were any enforcement actions against us or our senior officers to arise, we could be excluded from participation in U.S. government healthcare programs such as Medicare and Medicaid.

If we are unable to protect our intellectual property, our competitors could develop and market products similar to ours that may reduce demand for our products.

Our success, competitive position and potential future revenues will depend in significant part on our ability to protect our intellectual property. We rely on the patent, trademark, copyright and trade secret laws of the U.S. and other countries, as well as confidentiality and nondisclosure agreements, to protect our intellectual property rights. We apply for patents covering our technologies as we deem appropriate.

NovaBay aggressively protects and enforces its patent rights worldwide. However, certain risks remain. There is no assurance that patents will issue from any of our applications or, for those patents we have or that do issue, that the claims will be sufficiently broad to protect our proprietary rights, or that it will be economically possible to pursue sufficient numbers of patents to afford significant protection. For example, we do not have any composition of matter patent directed to the i-Lid Cleanser, CelleRx or NeutroPhase composition. If a potential competitor introduces a similar method of using i-Lid Cleanser, CelleRx or NeutroPhase with a similar composition that does not fall within the scope of the method of treatment claims, then we or a potential marketing partner would be unable to rely on the allowed claims to protect its market position for the method of using the i-Lid Cleanser, CelleRx or NeutroPhase composition, and any revenues arising from such protection would be adversely impacted.

In addition, there is no assurance that any patents issued to us or licensed or assigned to us by third parties will not be challenged, invalidated, found unenforceable or circumvented, or that the rights granted there under will provide competitive advantages to us. If we or our collaborators or licensors fail to file, prosecute or maintain certain patents, our competitors could market products that contain features and clinical benefits similar to those of any products we develop, and demand for our products could decline as a result. Further, although we have taken steps to protect our intellectual property and proprietary technology, third parties may be able to design around our patents or, if they do infringe upon our technology, we may not be successful or have sufficient resources in pursuing a claim of

infringement against those third parties. Any pursuit of an infringement claim by us may involve substantial expense and diversion of management attention.

We also rely on trade secrets and proprietary know-how that we seek to protect by confidentiality agreements with our employees, consultants and collaborators. If these agreements are not enforceable, or are breached, we may not have adequate remedies for any breach, and our trade secrets and proprietary know-how may become known or be independently discovered by competitors.

We operate in the State of California. The laws of the State prevent us from imposing a delay before an employee who may have access to trade secrets and proprietary know-how can commence employment with a competing company. Although we may be able to pursue legal action against competitive companies improperly using our proprietary information, we may not be aware of any use of our trade secrets and proprietary know-how until after significant damage has been done to our company.

Furthermore, the laws of foreign countries may not protect our intellectual property rights to the same extent as the laws of the U.S. If our intellectual property does not provide significant protection against foreign or domestic competition, our competitors, including generic manufacturers, could compete more directly with us, which could result in a decrease in our market share. All of these factors may harm our competitive position.

If our competitors develop products similar to i-Lid Cleanser, CelleRx or NeutroPhase, we may need to modify or alter our business strategy, which may delay the achievement of our goals. *

Competitors may develop products with similar characteristics to i-Lid Cleanser, CelleRx or NeutroPhase. Such similar products marketed by larger competitors can hinder our efforts to penetrate the market. As a result, we may be forced to modify or alter our business and regulatory strategy and sales and marketing plans, as a response to changes in the market, competition and technology limitations, among others. Such modifications may pose additional delays in achieving our goals.

If bacteria develop resistance to Aganocide compounds, i-Lid Cleanser, CelleRx or NeutroPhase, our potential revenues could be significantly reduced. *

Based on our understanding of the hypothesis of the mechanism of action of our Aganocide compounds and i-Lid Cleanser, CelleRx or NeutroPhase, we do not expect bacteria to be able to develop resistance to either of these compounds. However, we cannot assure you that one or more strains of bacteria will not develop resistance to our compounds, either because our hypothesis of the mechanism of action is incorrect or because a strain of bacteria undergoes some unforeseen genetic mutation that permits it to survive. Since we expect lack of resistance to be a major factor in the commercialization of our product candidates, the discovery of such resistance would have a major adverse impact on the acceptability and potential sales of our products.

If physicians and patients do not accept and use our products, we will not achieve sufficient product revenues and our business will suffer.

Even if the FDA approves product candidates that we develop, physicians and patients may not accept and use them. Acceptance and use of our products may depend on a number of factors including:

- perceptions by members of the healthcare community, including physicians, about the safety and effectiveness of our products;
- published studies demonstrating the cost-effectiveness of our products relative to competing products;
- availability of reimbursement for our products from government or healthcare payers; and
- effectiveness of marketing and distribution efforts by us and our licensees and distributors, if any.

The failure of any of our products to find market acceptance would harm our business and could require us to seek additional financing.

If we are unable to develop our own sales, marketing and distribution capabilities, or if we are not successful in contracting with third parties for these services on favorable terms, or at all, revenues from any products we develop could be disappointing. *

We currently have limited sales, marketing and distribution capabilities. To commercialize i-Lid Cleanser, CelleRx, NeutroPhase, or any other product candidate that may be approved by the FDA, we will either have to develop such capabilities internally or collaborate with third parties that can perform these services for us, such as PDI, Inc., Principle Business Enterprises in the U.S. and Pioneer Pharma Co. Ltd. in China. In the process of commercializing our products, we may not be able to hire the necessary experienced personnel and build sales, marketing and distribution operations which are capable of successfully launching new products and generating sufficient product revenues. In addition, establishing such operations will take time and involve significant expense.

If we decide to enter into co-promotion or other licensing arrangements with third parties, we may be unable to identify acceptable partners because the number of potential partners is limited and because of competition from others for similar alliances with potential partners. Even if we are able to identify one or more acceptable partners, we may not be able to enter into any partnering arrangements on favorable terms, or at all. If we enter into any partnering arrangements, our revenues are likely to be lower than if we marketed and sold our products ourselves.

In addition, any revenues we receive would depend upon our partners' efforts which may not be adequate due to lack of attention or resource commitments, management turnover, and change of strategic focus, further business combinations or other factors outside of our control. Depending upon the terms of our agreements, the remedies we have against an under-performing partner may be limited. If we were to terminate the relationship, it may be difficult or impossible to find a replacement partner on acceptable terms, or at all.

If we cannot compete successfully for market share against other companies, we may not achieve sufficient product revenues and our business will suffer.

The market for our products and product candidates is characterized by intense competition and rapid technological advances. If our product candidates receive FDA approval and are launched they will compete with a number of existing and future drugs, devices and therapies developed, manufactured and marketed by others. Existing or future competing products may provide greater therapeutic convenience or clinical or other benefits for a specific indication than our products, or may offer comparable performance at a lower cost. If our products are unable to capture and maintain market share, we may not achieve sufficient product revenues and our business will suffer.

We will compete for market share against fully integrated pharmaceutical and medical device companies or other companies that develop products independently or collaborate with larger pharmaceutical companies, academic institutions, government agencies and other public and private research organizations. In addition, many of these competitors, either alone or together with their collaborative partners, have substantially greater capital resources, larger research and development staffs and facilities, and greater financial resources than we do, as well as significantly greater experience in:

- developing drugs and devices;
- conducting preclinical testing and human clinical trials;
- obtaining FDA and other regulatory approvals of product candidates;
 - formulating and manufacturing
 - products; and
- launching, marketing, distributing and selling products.

Our competitors may:

- develop and patent processes or products earlier than we will;
- develop and commercialize products that are less expensive or more efficient than any products that we may develop;
 - obtain regulatory approvals for competing products more rapidly than we
 - will; and
- improve upon existing technological approaches or develop new or different approaches that render any technology or products we develop obsolete or uncompetitive.

We cannot assure you that our competitors will not succeed in developing technologies and products that are more effective than any developed by us or that would render our technologies and any products we develop obsolete. If we are unable to compete successfully against current or future competitors, we may be unable to obtain market acceptance for any product candidates that we create, which could prevent us from generating revenues or achieving profitability and could cause the market price of our common stock to decline.

Our ability to generate revenues from our current products and any products we develop will be diminished if we fail to obtain acceptable prices or an adequate level of reimbursement for our products from healthcare payers.

Our ability to commercialize our product candidates will depend, in part, on the extent to which health insurers, government authorities and other third-party payers will reimburse the costs of products which may be developed by us or our partners. We expect that a portion of our economic return from partnering arrangements with pharmaceutical companies and other collaborators will be derived from royalties, fees or other revenues linked to final sales of products that we or our partners develop. Newly-approved pharmaceuticals and other products which are developed by us or our partners will not necessarily be reimbursed by third-party payers or may not be reimbursed at levels sufficient to generate significant sales. Government and other third-party payers are increasingly attempting to contain health care costs by limiting both coverage and the level of reimbursement for new drugs or medical devices. Cost control initiatives such as these could adversely affect our or our collaborators' ability to commercialize products. In addition, real or anticipated cost control initiatives for final products may reduce the willingness of pharmaceutical companies or other potential partners to collaborate with us on the development of new products.

Significant uncertainty exists as to the reimbursement status of newly-approved healthcare products. Healthcare payers, including Medicare, health maintenance organizations and managed care organizations, are challenging the prices charged for medical products or are seeking pharmacoeconomic data to justify formulary acceptance and reimbursement practices. We currently have not generated pharmacoeconomic data on any of our product candidates. Government and other healthcare payers increasingly are attempting to contain healthcare costs by limiting both coverage and the level of reimbursement for drugs and medical devices, and by refusing, in some cases, to provide coverage for uses of approved products for disease indications for which the FDA has or has not granted labeling approval. Adequate third-party insurance coverage may not be available to patients for any products we discover and develop, alone or with collaborators. If government and other healthcare payers do not provide adequate coverage and reimbursement levels for our products, market acceptance of our product candidates could be limited.

Risks Relating to Owning Our Common Stock

The price of our common stock may fluctuate substantially, which may result in losses to our stockholders.

The stock prices of many companies in the pharmaceutical and biotechnology industry have generally experienced wide fluctuations, which are often unrelated to the operating performance of those companies. The market price of our common stock is likely to be volatile and could fluctuate in response to, among other things:

- the results of preclinical or clinical trials relating to our product candidates;
- the announcement of new products by us or our competitors;
- announcement of partnering arrangements by us or our competitors;
- quarterly variations in our or our competitors' results of operations;
- announcements by us related to litigation;
- changes in our earnings estimates, investors' perceptions, recommendations by securities analysts or our failure to achieve analysts' earnings estimates;
- developments in our industry; and
- general, economic and market conditions, including the recent volatility in the financial markets and decrease in consumer confidence and other factors unrelated to our operating performance or the operating performance of our competitors.

The volume of trading of our common stock may be low, leaving our common stock open to risk of high volatility.

The number of shares of our common stock being traded may be very low. Any stockholder wishing to sell his/her stock may cause a significant fluctuation in the price of our stock. In addition, low trading volume of a stock increases the possibility that, despite rules against such activity, the price of the stock may be manipulated by persons acting in

their own self-interest. We may not have adequate market makers and market making activity to prevent manipulation.

Our directors, executive officers and principal stockholders have significant voting power and may take actions that may not be in the best interests of our other stockholders.

As of June 30, 2014, our officers and directors collectively controlled approximately 3,726,072 shares of our outstanding common stock (and approximately 3,867,291 shares of our common stock when including options held by them which were exercisable as of or within 60 days from June 30, 2014). Furthermore, as of June 30, 2014, our second largest stockholder is Dr. Ramin Najafi, our Chairman and Chief Executive Officer. Dr. Najafi individually, and through his family trust which he jointly controls with his wife Mrs. Farideh Najafi, owns 3,403,180 shares, or 6.70% of our outstanding common stock (including 17,812 options held by Dr. Najafi which are exercisable as of or within 60 days from June 30, 2014). As a result, Dr. Najafi, can significantly influence the management and affairs of our company and most matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions. This concentration of ownership may have the effect of delaying or preventing a change in control and might adversely affect the market price of our common stock. This concentration of ownership may not be in the best interests of our other stockholders.

Our limited operating history may make it difficult for you to evaluate our business and to assess our future viability.

Our operations to date have been limited to organizing and staffing our company, developing our technology, researching and developing our compounds, and conducting preclinical studies and early-stage clinical trials of our compounds. We have not demonstrated the ability to succeed in achieving clinical endpoints, obtain regulatory approvals, formulate and manufacture products on a commercial scale or conduct sales and marketing activities. Consequently, any predictions you make about our future success or viability are unlikely to be as accurate as they could be if we had a longer operating history.

Our amended and restated certificate of incorporation and bylaws and Delaware law, contain provisions that could discourage a third party from making a takeover offer that is beneficial to our stockholders.

Anti-takeover provisions of our amended and restated certificate of incorporation, amended and restated bylaws and Delaware law may have the effect of deterring or delaying attempts by our stockholders to remove or replace management, engage in proxy contests and effect changes in control. The provisions of our charter documents include:

- a classified board so that only one of the three classes of directors on our Board of Directors is elected each year;
- elimination of cumulative voting in the election of directors;
- procedures for advance notification of stockholder nominations and proposals;
- the ability of our Board of Directors to amend our bylaws without stockholder approval; and
- the ability of our Board of Directors to issue up to 5,000,000 shares of preferred stock without stockholder approval upon the terms and conditions and with the rights, privileges and preferences as our Board of Directors may determine.

In addition, as a Delaware corporation, we are subject to the Delaware General Corporation Law, which includes provisions that may have the effect of deterring hostile takeovers or delaying or preventing changes in control or management of our company. Provisions of the Delaware General Corporation Law could make it more difficult for a third party to acquire a majority of our outstanding voting stock by discouraging a hostile bid, or delaying, preventing or deterring a merger, acquisition or tender offer in which our stockholders could receive a premium for their shares, or effect a proxy contest for control of NovaBay or other changes in our management.

We have not paid dividends in the past and do not expect to pay dividends in the future, and any return on investment may be limited to the value of our stock.

We have never paid cash dividends on our common stock and do not anticipate paying cash dividends on our common stock in the foreseeable future. The payment of dividends on our common stock will depend on our earnings, financial condition and other business and economic factors affecting us at such time as our Board of Directors may consider relevant. If we do not pay dividends, you will experience a return on your investment in our shares only if our stock price appreciates. We cannot assure you that you will receive a return on your investment when you do sell your shares or that you will not lose the entire amount of your investment.

ITEM 6. EXHIBITS

See the Exhibit Index which follows the signature page of this Quarterly Report on Form 10-Q, which is incorporated here by reference.

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: July 31, 2014 NOVABAY PHARMACEUTICALS, INC.

/s/ Ramin Najafi
Ramin (“Ron”) Najafi
Chairman and Chief Executive Officer

(duly authorized officer)

Date: July 31, 2014 /s/ Thomas J. Paulson
Thomas J. Paulson
Chief Financial Officer

(principal financial officer)

EXHIBIT INDEX

Exhibit No. Description

3.1	Certificate of Incorporation of NovaBay Pharmaceuticals, Inc., a Delaware corporation (Incorporated by reference to the exhibit of the same number from the Company's current report on Form 8-K, as filed with the SEC on June 29, 2010 (SEC File No. 001-33678))
3.2	Amended and Restated Bylaws of registrant (Incorporated by reference to the exhibit of the same number from the Company's current report on Form 8-K as filed with the SEC on June 29, 2010 (SEC File No. 001-33678).)
3.3	Certificate of Amendment to Amended and Restated Certificate of Incorporation (Incorporate by reference to Exhibit 3.1 to the Company's current report on Form 8-K, as filed with the SEC on June 4, 2014 (SEC File No. 001-33678).)
4.1	Form of Warrant issued in the August 2009 offering. (Incorporated by reference to Exhibit 4.3 to the Company's current report on Form 8-K, as filed with the SEC on August 21, 2009 (SEC File No. 001-33678).)
4.2	Form of Warrant issued in the July 2011 offering. (Incorporated by reference to Exhibit 4.1 to the Company's current report on Form 8-K, as filed with the SEC on June 29, 2011 (SEC File No. 001-33678).)
10.1	2014 Bonuses for Named Executive Officers (Incorporated by reference to the Company's current report on Form 8-K as filed with the SEC on April 18, 2014 (SEC File No. 001-33678).)
31.1	Certification of the principal executive officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of the principal financial officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of the chief executive officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of the chief financial officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS*	XBRL Instance Document
101.SCH*	XBRL Taxonomy Extension Schema Document
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF*	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB*	XBRL Taxonomy Extension Label Linkbase Document

101.PRE* XBRL Taxonomy Extension Presentation Linkbase Document

* XBRL information is furnished and not filed for purposes of Sections 11 and 12 of the Securities Act of 1933 and Section 18 of the Securities Exchange Act of 1934, is not part of any registration statement or prospectus to which it relates and is not incorporated or deemed to be incorporated by reference into any registration statement, prospectus or other document.