NovaBay Pharmaceuticals, Inc.
Form 10-K
March 30, 2010

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

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2009

OR

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

For the transition period from to

Commission file number 001-33678

NOVABAY PHARMACEUTICALS, INC.
(Exact name of registrant as specified in its charter)

California	68-0454536
(State or other jurisdiction of incorporation or organization)	(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

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, $0.01 par value per share	NYSE Amex

Securities registered pursuant to Section 12(g) of the Act:
Common Stock, $0.01 par value per share

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes o No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No x

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 x No o

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 x No ¨

Indicate by a check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

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

(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 o No x

As of June 30, 2009, the aggregate market value of the voting stock held by non-affiliates of the registrant, computed by reference to the last sale price of such stock as of such date on the NYSE Amex, was approximately $38,821,430. Excludes an aggregate of 4,085,037 shares of common stock held by officers and directors and by each person known by the registrant to own 5% or more of the outstanding common stock as of June 30, 2009. Exclusion of shares held by any of these persons should not be construed to indicate that such person possesses the power, direct or indirect, to direct or cause the direction of the management or policies of the registrant, or that such person is controlled by or under common control with the registrant.

As of March 19, 2010, there were 23,305,493 shares of the registrant's common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive Proxy Statement for the 2010 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission pursuant to Regulation 14A not later than 120 days after the end of the fiscal year covered by this Form 10-K, are incorporated by reference in Part III, Items 10-14 of this Form 10-K.

NOVABAY PHARMACEUTICALS, INC.
ANNUAL REPORT ON FORM 10-K
FOR THE FISCAL YEAR ENDED DECEMBER 31, 2009

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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.

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This report contains forward-looking statements that are based on our management's beliefs and assumptions and on information currently available to our management. These forward-looking statements include but are not limited to statements regarding our product candidates, market opportunities, competition, strategies, anticipated trends and challenges in our business and the markets in which we operate, and anticipated expenses and capital requirements. In some cases, you can identify forward-looking statements by terms such as "anticipates," "believes," "could," "estimates," "expects," "intends," "may," "plans," "potential," "predicts," "projects," "should," "will," "would" and similar expressions inte identify forward-looking statements. Forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements to be materially different from any future results, performances or achievements expressed or implied by the forward-looking statements. We discuss many of these risks in this report in greater detail under the heading "Risk Factors" in Item 1A of this report. Given these uncertainties, you should not place undue reliance on these forward-looking statements. You should read this report and the documents that we reference in this report and have filed as exhibits to the report completely and with the understanding that our actual future results may be materially different from what we expect. Also, forward-looking statements represent our management's beliefs and assumptions only as of the date of this report. Except as required by law, we assume no obligation to update these forward-looking statements publicly, or to update the reasons actual results could differ materially from those anticipated in these forward-looking statements, even if new information becomes available in the future.

PART I

ITEM 1. BUSINESS

Overview

We are a clinical stage specialty pharmaceutical company engaged in the discovery and development of novel, and synthetic anti-infective product candidates to treat and prevent a wide range of infections, without developing resistance, in hospital and non-hospital environments. Many of these infections are increasingly difficult to treat because of the rapid and growing rise in drug resistance. Our Aganocide® compounds are synthetic forms of N-chlorinated antimicrobial molecules, which are highly effective and rapidly-acting anti-infective molecules produced by white blood cells when defending the body against invading pathogens when used in topical applications. We have specifically designed our Aganocide class of compounds to mimic the human body's natural defense against infection. Importantly, this class of compounds may deliver the same or better efficacy as currently used antibiotics, but without contributing to the growing, global epidemic of drug-resistant bacteria. In preclinical testing, our Aganocide compounds have demonstrated the ability to destroy microbial pathogens. We believe that our Aganocide compounds could form a platform on which to create a variety of products to address differing needs in the treatment and prevention of non-systemic bacterial, viral and fungal infections.

We were 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 may conduct research and development in Canada, and DermaBay, Inc., a wholly-owned U.S. subsidiary, which may explore and pursue dermatological opportunities.

Our Target Indications and Product Candidates

Our goal is to advance our product candidates to confirmatory Phase II proof of concept trials, after which we will evaluate further advancing each program on our own or entering a co-development collaboration with a proven market leader to benefit from their expertise and proven capabilities, as well as to defray costs, while retaining participation in long-term commercial economics. We believe that this strategy is appropriate because of the significant breadth of non-systemic product opportunities that we believe can be developed from our technology base. In many instances, we believe we can build upon the safety data generated in one indication to accelerate early development of other indications. We are also learning from our own and our partners' experience in developing appropriate dosing and usage of our compounds. The more development programs that are undertaken by our partners and by ourselves, the greater the synergy in our activities.

Eye, Ear, Sinus and Contact Lens Solution

In August 2006, we entered into a collaboration and license agreement with Alcon Manufacturing Ltd. ("Alcon"), an affiliate of Alcon, Inc., that provides Alcon with the exclusive rights to develop, manufacture and commercialize products incorporating our Aganocide compounds for the treatment of eye, ear and sinus infections as well as for use in contact lens solutions. Under the terms of the agreement, Alcon paid an up-front, non-refundable, non-creditable technology access fee of $10.0 million upon the effective date of the agreement. In addition to the technology access fee, we are entitled to receive semi-annual payments from Alcon to support on-going research and development activities over the four year funding term of the agreement. The collaboration also calls for Alcon to pay for all development and clinical costs.

The research and development support payments include amounts to fund a specified number of personnel engaged in collaboration activities and to reimburse for qualified equipment, materials and contract study costs. As product candidates are developed and proceed through clinical trials and approval, we will receive milestone payments. If the products are commercialized, we will also receive royalties on any sales of products containing the Aganocide compounds. From the inception of the agreement to December 31, 2009, we have received $21.7 million from Alcon including the technology access fee, milestone payments and R&D funding.

NovaBay retains the rights to market, via a third-party co-marketing partner, any products developed for ear or sinus indications in the major Asian markets, including Japan, China, India and South Korea. NovaBay has also retained such rights in other markets where Alcon is not committing reasonably sufficient sales and marketing resources to the particular product. In each instance, the appointment of the co-marketing partner would be subject to certain conditions, including that the co-marketing partner be approved by Alcon. The co-marketing partner, or NovaBay on its behalf, would be required to pay Alcon a royalty based on net sales of the product in the applicable market and would also be required to reimburse Alcon for part of its local development costs or, in markets in which Alcon is not committing reasonably sufficient sales and marketing resources, all of its local development costs. These products may also be marketed in those markets by Alcon, its affiliates or distributors.

In December 2009 we announced that Alcon has increased its on-going financial support of the company's research and development efforts by more than $2 million per year. The additional funding is expected to enhance NovaBay's pre-clinical and clinical development programs in the areas of eye, ear and sinus infections, as well as contact lens care. Alcon is conducting Phase II human trials of NovaBay's lead compound, NVC-422, for the treatment of viral conjunctivitis, a type of "Pink Eye". The viral conjunctivitis trials are under way at 30 medical centers around the U.S. and expect to enroll approximately 250 patients.

Dermatology

We are focused on developing products that will potentially eliminate the need to use antibiotic-based products in the dermatology market. In laboratory testing, we have shown that our lead Aganocide compound NVC-422 kills P. acne, the bacterium associated with inflamed acne lesions, and other known dermal pathogens. We have been in advanced preclinical development of a variety of formulations for use in the treatment of skin infections. We are currently conducting Phase II clinical proof of concept studies for the treatment of impetigo. Impetigo is a highly contagious bacterial skin infection and one of the most common skin diseases among children. This infection is increasingly being caused by MRSA (methacillin resistant Staph. aureus). In these cases, antibiotic treatments are limited.

On March 25, 2009, we announced that we 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. We amended this agreement in December 2009. The agreement is exclusive and worldwide in scope, with the exception of Asian markets and North America. In Asian markets we have commercialization rights. In North America we have an option to exercise co-promotion rights.

Galderma will be responsible for the development costs of the acne and other indications with two exceptions. First, in Japan Galderma has the option to request that we share such development costs. Second, at this time we are supporting the ongoing development program for impetigo; however, upon the achievement of a specified milestone, Galderma will reimburse NovaBay for associated expenses. NovaBay retains the right to co-market products resulting from the agreement in Japan. In addition, NovaBay has retained all rights in other Asian markets outside Japan, and has the right to co-promote the products developed under the agreement in the hospital and other healthcare institutions in North America.

Galderma paid to NovaBay certain upfront fees at the inception of the contract and will continue to pay 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. Upon the termination of the agreement under certain circumstances, Galderma will grant NovaBay certain technology licenses which would require NovaBay to make royalty payments to Galderma for such licenses with royalty rates in the low- to mid-single digits.

We recently announced that we received $3.75 million in milestone payments from Galderma: a $2.0 million milestone payment having been triggered by the completion of formulation feasibility studies with our Aganocide compound for topical use and a $1.75 million milestone payment was for completing an exploratory clinical study for the treatment of adult acne. These milestones were reached in 2009 and therefore the revenue was recorded in 2009 and the related receivable is included in our balance sheet as of December 31, 2009; we received payment on these receivables in January 2010.

CVC Lock

Every year in the United States, physicians place more than 5 million central venous catheter (CVC) lines, or a catheter placed into a large vein for the purpose of administering medication or fluids. Long-term CVC lines are at risk of infection introduced through the catheter during connections. The incidence of catheter related blood stream infection during such use is significant and its consequences severe and costly to treat. Heparin is most commonly used as a lock solution, or a solution to fill the catheter line, when CVC lines are not being accessed. No lock solutions other than heparin and saline are approved in the United States.

NovaBay is nearing completion of a number of preclinical studies that it believes will confirm the ability of solutions of NVC-422 to prevent colonization of CVC lines by a wide spectrum of pathogens with a low potential for resistance at safe doses. The company is evaluating development of NVC-422 lock solutions for prophylaxis against blood stream infections in dialysis, oncology and parenteral nutrition and intends to follow the pre-market approval regulatory path in the United States.

Onychomycosis

Onychomycosis is a nail dermatophytosis of clinical significance caused by dermatophytes, the fungi that commonly cause skin infections, like Trichophyton rubrum and Trichophyton mentagrophytes. Onychomycosis is a fungal infection of the toe and finger nails affecting the components of the nail matrix, nail bed, or nail plate resulting in deformity of the nail plate, thickening and nail discoloration. Onychomycosis is not life threatening; however, it can cause disfigurement and pain resulting in serious occupational and physical limitations. Furthermore, individuals with a compromised immune system may be at greater risk of additional complications. Aganocides, like NVC-422, have been shown in laboratory tests to kill the dermatophytes responsible for Onychomycosis thus providing NovaBay Pharmaceuticals with an opportunity to provide effective treatment of this disease.

Catheter Associated Urinary Tract Infections

Urinary tract catheters have become a routine part of the management of patients in intensive care and long-term care settings with an estimated five million patients undergoing catheterization each year. Catheter associated urinary tract infections (“CAUTI”) are the most frequent healthcare-associated infections, accounting for more than 40% of all healthcare-associated infections, or one million infections per year. These infections generally prolong hospitalization, require intensive antibiotic therapy and greatly increase the cost of treatment. A contributing factor in CAUTI is the formation of bacterial biofilm within the catheter. This biofilm provides an on-going reservoir of bacteria that can cause infection. We are developing a formulation of NVC-422 that may destroy bacteria in the bladder as well as controlling bacteria that have formed biofilm within the catheter, with the intent of keeping the catheter unblocked, referred to as maintaining catheter patency. We successfully completed Phase I clinical trials that established the safe and well-tolerated nature of our CAUTI formulation. We are currently in Phase IIa clinical trials to explore the therapeutic potential of NVC-422 for the treatment of bacteruria in the bladder under different dosing regimens and our eventual initiation of catheter patency trial which we expect to occur in 2010.

Wound Care

Wound infections prevent wounds from healing and can cause serious bloodstream infections. We have developed NVC-101, a solution of hypochlorous acid that we have trademarked as NeutroPhase™, to address this major problem. We have received two 510K clearances from the FDA for the marketing of this product as a wound cleanser and debriding agent. We continue to explore the potential for NVC-101 and the Aganocide compounds in woundcare.

Our Technology and Research

We have developed our lead compounds by understanding the nature of the antimicrobial molecules that are produced by the human body’s white blood cells to kill pathogens such as bacteria, viruses and fungi. Once the body’s defense system detects these pathogens, white blood cells produce small, highly active molecules that kill the pathogens in an extremely efficient manner. These molecules are not readily usable as pharmaceutical products because our body produces them “on demand” and the molecules are not naturally stable. We have discovered ways to stabilize one of these naturally occurring molecules, which we call NVC-101 or NeutroPhase. Through the modification of another of these natural molecules, we have created NVC-422, which is our lead Aganocide compound. NVC-422 is a stable analog of naturally occurring N-chlorotaurine (“NCT”). We believe NVC-422 is safer and more potent than the naturally occurring NCT molecule. We have made significant discoveries over the past year that have enhanced our

understanding of why the naturally generated molecules cannot be kept stable and used as drugs. We have also been exploring different Aganocide compounds that have been invented by NovaBay's scientists with the aim of creating molecules that can penetrate different tissues more effectively, or that can enhance the duration of antimicrobial activity. We have also made great progress in developing different formulations that can enhance the penetration of the Aganocide molecules.

In 2002, the World Health Organization predicted that within ten years we will enter a "post-antibiotic" era, where there will be infections for which there will be no effective antibiotic treatments. It is beginning to look as if that prediction may have been overoptimistic as there are more multidrug resistant bacteria appearing, and even a few pan-resistant species. By using nature's blueprint for the development of new anti-infective products, we start with the intent that the natural molecules do not allow pathogens to develop resistance. Extensive laboratory studies appear to confirm that the Aganocide compounds should exhibit this characteristic. The intended ability of our Aganocide compounds to be effective without developing resistance would be critical in a situation where bacteria are continuing to develop ever more sophisticated mechanisms for protecting themselves from antibiotics.

Additionally, we continue to expand our understanding of the activity of the Aganocide compounds against bacteria in biofilm. Just as bacteria are found everywhere, we now understand that biofilm is a natural, ever present defense mechanism of bacteria. Biofilm is a cocoon-like shield that forms around a colony of bacteria. Once the biofilm is formed, bacteria go into dormancy. Dormant bacteria reproduce once every few days, while an active bacteria reproduces every 30 to 60 minutes. Antibiotics are generally only effective against fast reproducing bacteria. In controlled laboratory studies, our Aganocide compounds were found to be highly effective at killing bacteria in biofilm. We believe their activity in biofilm is a critical element of their success, particularly in the prevention of catheter associated urinary tract infections.

Research and Development

As of December 31, 2009, we had 29 employees dedicated to research and development. Our research and development expenses consist primarily of personnel-related expenses, laboratory supplies and contract research services provided to our research, development and clinical groups. We expense our research and development costs as they are incurred. Research and development expenses for 2007, 2008 and 2009 were $7.4 million, $9.6 million, and $7.3 million, respectively. All of our research and development employees are engaged in drug research and development activities, including those related to the Alcon and Galderma agreement described above. We expect to incur significant research and development expenses for the foreseeable future.

Intellectual Property

We rely on a combination of patent, trademark, copyright and trade secret laws in the United States and other jurisdictions, as well as confidentiality procedures and contractual provisions, to protect our proprietary technology. We also enter into confidentiality and invention assignment agreements with our employees and consultants and confidentiality agreements with other third parties, and we rigorously control access to our proprietary technology.

We have pending applications in the United States and major foreign countries for the following marks: AgaDerm, AgaNase, Aganocide, NeutroPhase, and NovaBay. We have registered the NovaBay Pharma and Design trademark in the United States, the NovaBay trademark in the U.S., the European Community, Israel, Mexico, and Australia; the NeutroPhase trademark in Australia, the European Community, Ireland and the United Kingdom; the Aganocide trademark in the United States, the European Community and Japan; and the AgaNase trademark in the U.S., the European Community Australia, Israel, Japan, Mexico, China, South Korea, and Taiwan.

We are the assignee on record for three issued patents, eleven pending utility applications, and several provisional applications in the United States. In addition to our U.S. patents and applications, we seek patent protection in key foreign countries. We have one issued patent in China, Hong Kong, Israel, India, Mexico, and South Korea, and pending applications filed under the Patent Cooperation Treaty in various stages of examination.

The subject matter of our patents and patent applications covers four key areas: methods relating to the manufacture and use of NVC-101, compositions of matter of the Aganocide compounds, methods of treatment utilizing the Aganocide compounds, and formulations.

Our first issued patent in the U.S. provides coverage for a method of treating burns or promoting wound healing, or tissue repair or tissue regeneration using a specific range of formulations of NVC-101. This patent was issued on July 30, 2002 and will expire in 2020 with payment of maintenance fees. Our second issued patent in the U.S. provides coverage for a method of disinfecting open wounds and burns, promoting wound healing or providing ocular disinfection using a specific range of formulations of NVC-101. This patent was issued on July 1, 2008 and will expire in 2020 with payment of maintenance fees. Our third issued patent in the U.S. provides composition-of-matter coverage of our lead development candidate, NVC-422, and other Aganocide compounds. This patent was issued on December 9, 2008 and will expire in 2026 with payment of maintenance fees.

Competition

The market for non-systemic drugs and medical devices designed to treat or prevent bacterial, fungal or viral infections is highly competitive. If developed, and commercialized, our products would compete against a wide variety of existing products, products and technologies that are currently in development, and products and technologies that could be developed and reach the market before or after our products. In particular, we would be competing against existing antibiotics that are sold by many major pharmaceutical companies, or generic equivalents that are being distributed, typically at low prices. NeutroPhase, if launched for use in wound management, will be competing against multiple products with similar indications for use. However, we believe there is currently no dominant product in this indication.

Our potential competitors include large and small pharmaceutical and medical device companies, such as Pfizer, Inc., Johnson & Johnson, Abbott Grp. Plc., GlaxoSmithKline Plc, Sanofi-Aventis SA, Novartis AG, Smith & Nephew Plc, C.R. Bard, Puricore and Oculus Innovative Sciences. Some of these competitors may have far greater resources and experience in the area than we do and may develop and patent processes or products earlier than we are able to, 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 are able to, and improve upon existing technological approaches or develop new or different approaches that render any technology or products we develop obsolete or uncompetitive.

We believe the principal competitive factors for our products in our target markets include their effectiveness in killing bacteria, including bacteria in biofilm, very low potential for the development of resistance, time to kill bacteria, safety, side effects and cost effectiveness. We believe that our compounds may, if approved by the regulatory authorities, have significant advantages over existing compounds and compounds in development of which we are aware, because our Aganocide and NVC-101 compounds could be used to prevent infections or to treat infections where speed of action, action against infections with bacterial and viral componants such as conjunctivitis, action against bacteria in biofilm, action in topical indications or action against multi-drug resistant bacteria is important.

Manufacturing and Supply

We do not currently operate manufacturing facilities for clinical or commercial production, as we rely on and leverage the manufacturing and distribution infrastructure of third parties. We have no plans to establish our own manufacturing facilities in the future. Third party vendors supply us with the Active Pharmaceutical Ingredient (“API”) of NVC-422 and the finished clinical trials materials for NVC-101, which are manufactured in compliance with the FDA’s “Current Good Manufacturing Practice”, or CGMP, regulations. We also intend to work with third parties for future clinical trial materials and commercial supplies of NVC-422 and our other Aganocide compounds.

The Alcon and Galderma agreements provide for the manufacture by Alcon and Galderma of finished dosage forms of products incorporating Aganocide compounds for sale under our label in those markets where we have retained marketing rights.

Sales and Marketing

Our lead product candidate, NVC-422, as well as many of the product candidates we expect to develop in the future, are primarily intended to address a variety of different non-systemic market segments, some of which are large, primary care markets. We do not currently have, nor do we intend in the near term to create, a commercialization organization capable of marketing, selling and distributing our targeted product candidates to large, primary care markets. This applies to markets in both the United States and elsewhere. Rather, we intend to establish commercialization partnerships with pharmaceutical, biotechnology or other leading organizations with the experience and resources to bring our products to market. In some cases, we may enter into agreements with these organizations during the development stage of a product candidate to further benefit from their clinical development, regulatory, market research, pre-marketing and other expertise, as is the case with Alcon and Galderma. As appropriate, we may establish a specialty sales force with expertise in marketing and selling any future approved products to specialty physicians for specific target indications. We may also establish other complementary capabilities related to marketing and selling targeted medicines, particularly where those capabilities may not currently exist at other organizations. Substantially all of our long-lived assets are located in the United States.

Government Regulation

The testing, manufacturing, labeling, advertising, promotion, distribution, export and marketing of our product candidates are subject to extensive regulation by the FDA, state agencies and comparable regulatory authorities in other countries. Because our programs involve product candidates that are considered as drugs and others that are medical devices, we intend to submit applications to regulatory agencies for approval or clearance of both drug and medical device product candidates.

U.S. Government Regulation

In the United States, the FDA regulates drugs and medical devices under the Federal Food, Drug, and Cosmetic Act and the agency’s implementing regulations. If we fail to comply with the applicable United States requirements at any time during the product development process, clinical testing, and the approval process or after approval, we may

become subject to administrative or judicial sanctions. These sanctions could include the FDA's refusal to approve pending applications, license suspension or revocation, withdrawal of an approval, warning letters, adverse publicity, product recalls, product seizures, total or partial suspension of production or distribution, injunctions, fines, civil penalties or criminal prosecution. Any agency enforcement action could have a material adverse effect on us.

Our products may be classified by the FDA as a drug or a medical device depending upon the mechanism of action and indications for use or claims. The use of NVC-101 as a solution for cleansing and debriding wounds is considered a medical device. Similarly, NVC-422 may be classified as a medical device depending on the indication for use. For example, we believe if the indication is for maintaining catheter patency, it would be classified as a medical device, whereas we believe it would be considered a drug when it is indicated for the prevention of urinary tract infection. The determination as to whether a particular product and indication is considered a drug or a device is based in part upon prior precedent.

Drug Approval Process

The process required by the FDA before a drug may be marketed in the United States generally involves satisfactorily completing each of the following:

- preclinical laboratory tests, animal studies and formulation studies all performed in accordance with the FDA's Good Laboratory Practice regulations;
- submission to the FDA of an Investigational New Drug ("IND") application for human clinical testing, which must become effective before human clinical trials may begin;
- performance of adequate and well-controlled clinical trials to establish the safety and efficacy of the product candidate for each proposed indication; these clinical trials must be conducted in accordance with Good Clinical Practice ("GCP") Guidelines, including Institutional Review Board oversight of the consent of subjects and registration of applicable studies with clinicaltrials.gov;
- submission to the FDA of a New Drug Application ("NDA") including payment of substantial UserFees;
- satisfactory completion of an FDA inspection of the manufacturing facility or facilities, including those of third-parties, at which the product is produced to assess compliance with strictly enforced current GMP regulations, as well as FDA audit for GCP compliance of one or more clinical investigator sites; and
- FDA review and approval of the NDA before any commercial marketing, sale or shipment of the product.

There is continuing and pervasive FDA regulation of drug product manufacturing, labeling, advertising and promotion once approved.

Medical Devices

NeutroPhase, as well as some of our product candidates, may be regulated as medical devices. Unless an exception applies, each medical device we wish to commercialize in the United States will require either prior 510(k) clearance or premarket approval from the FDA. The FDA classifies medical devices into one of three classes. Devices deemed to pose lower risks are placed in either Class I or II, which requires the manufacturer to submit to the FDA a premarket notification requesting permission to commercially distribute the device. This process is generally known as 510(k) clearance. Some low risk devices are exempt from this requirement. Any post-clearance modifications made to a 510(k) device may require the submission of a new 510(k) notification prior to commercialization. Devices deemed by the FDA to pose the greatest risk, such as life-sustaining, life-supporting or implantable devices, or devices deemed not substantially equivalent to a previously cleared 510(k) device, are placed in Class III, requiring premarket approval.

Continuing Food and Drug Administration Regulation of Medical Devices

After the FDA permits a device to enter commercial distribution, numerous regulatory requirements apply. These include:

- the FDA's Quality Systems Regulations ("QSRs"), which require manufacturers to follow stringent design, testing, production, control, labeling, packaging, storage, shipping, documentation and other quality assurance procedures during all aspects of the manufacturing process;
- labeling regulations which impose restrictions on labeling and promotional activities, and FDA prohibitions against the promotion of products for uncleared, unapproved, or "off-label" uses;
- post-market surveillance requirements which apply when necessary to protect the public health or to provide additional safety and effectiveness data for the device;
- the FDA Medical Device Reporting regulations, which require that manufacturers report to the FDA if their device may have caused or contributed to a death or serious injury or malfunctioned in a way that would likely cause or contribute to a death or serious injury if it were to recur; and
- notices of correction or removal, and recall regulations.

In addition, we are required to register our facility and list our products with the FDA, and are be subject to unannounced inspections by the FDA and the Food and Drug Branch of the California Department of Health Services to determine compliance with the QSRs and other regulations, and these inspections may include the manufacturing facilities of our subcontractors.

International Regulation

In addition to being subject to the laws and regulations in the United States, we will be subject to a variety of laws and regulations in those other countries in which we seek to study and commercialize products. European and Canadian regulatory requirements and approval processes are similar in principle to those in the United States. Whether or not we obtain FDA approval for a product, we must obtain approval of a product by the comparable regulatory authorities of the European Union, European countries, Canada and other countries before we can commence clinical trials or marketing of the product in those respective countries. The approval process may be longer or shorter than that required for FDA approval. The requirements governing pricing, reimbursement, clinical trials, and to a lesser extent, product licensing vary from country to country.

Third Party Reimbursement and Pricing Controls

In the United States and elsewhere, sales of pharmaceutical products depend in significant part on the availability of reimbursement to the consumer from third party payors, such as government and private insurance plans. Third party payors are increasingly challenging the prices charged for medical products and services. It will be time consuming and expensive for us to go through the process of seeking reimbursement from Medicare and private payors. Aganocide products from which we may receive revenue in the future may not be considered cost-effective, and reimbursement may not be available or sufficient to allow these products to be sold on a competitive and profitable basis.

Anti-Kickback and False Claims Laws

In the United States, we are subject to various federal and state laws pertaining to healthcare "fraud and abuse," including anti-kickback and false claims laws. The federal Anti-Kickback Law makes it illegal for any person, including a prescription drug or medical device manufacturer (or a party acting on its behalf) to knowingly and willfully solicit, offer, receive or pay any remuneration, directly or indirectly, in exchange for, or to induce, the referral of business, including the purchase, order or prescription of a particular drug or device, for which payment may be made under federal healthcare programs such as Medicare and Medicaid. Violations of the law are punishable by up to five years in prison, criminal fines, administrative civil money penalties, and exclusion from participation in federal healthcare programs. In addition, many states have adopted laws similar to the federal Anti-Kickback Law. Some of these state prohibitions apply to referral of patients for healthcare services reimbursed by any source, not only the Medicare and Medicaid programs. Due to the breadth of these laws, it is possible that our future sales and marketing practices or our future relationships with physicians might be challenged under anti-kickback laws, which could harm us.

False claims laws prohibit anyone from knowingly presenting, or causing to be presented, for payment to third party payors (including Medicare and Medicaid) claims for reimbursed items or services, including drugs and medical devices, that are false or fraudulent, claims for items or services not provided as claimed, or claims for medically unnecessary items or services. Our future activities relating to the reporting of wholesaler or estimated retail prices for our products, the reporting of Medicaid rebate information and other information affecting federal, state and third party reimbursement of our products, and the sale and marketing of our products, will be subject to scrutiny under these laws. In addition, pharmaceutical and medical device companies have been prosecuted under the federal False Claims Act in connection with their off-label promotion of products. Suits filed under the False Claims Act, known as "qui tam" actions, can be brought by any individual on behalf of the government and such individuals (known as "relators" or, more commonly, as "whistleblowers") may share in the amounts paid by the entity to the government in fines or settlement.

Employees

As of December 31, 2009, we had 39 full-time employees, including 12 with doctoral degrees. Of our full time workforce, 29 employees were engaged in research and development, and 10 in finance and administration. None of our employees are represented by labor unions or covered by collective bargaining agreements. We consider our relationship with our employees to be good.

Available Information

Our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Sections 13(a) and 15(d) of the Securities Exchange Act of 1934, as amended, are available free of charge on our corporate website, located at www.novabaypharma.com, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission ("SEC").

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.

Risks Relating to Our Business

Current worldwide economic conditions may limit our access to capital, adversely affect our business and financial condition, as well as further decrease our stock price.

General worldwide economic conditions have experienced a downturn due to the effects of the subprime lending crisis, general credit market crisis, collateral effects on the finance and banking industries, concerns about inflation, slower economic activity, decreased consumer confidence, reduced corporate profits and capital spending, adverse business conditions and liquidity concerns. Although the impact of the downturn on our business is uncertain at this time, downturn may adversely affect our business and operations in a number of ways, including making it more difficult for us to raise capital as well as making it more difficult to enter into collaboration agreements with other parties. Like many other stocks, our stock price has been subject to fluctuations and has decreased substantially in recent months. Our stock price could further decrease due to concerns that our business, operating results and financial condition will be negatively impacted by a worldwide economic downturn.

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.

We expect our capital outlays and operating expenditures to substantially increase over at least the next several years as we expand our product pipeline and increase research and development efforts and clinical and regulatory activities. 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 any of our 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 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 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 and the credit crisis, 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 shareholders' ownership percentage would be diluted and new investors may demand rights, preferences or privileges senior to those of existing shareholders. 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. Although we were profitable in 2009, we do not have any commercial products, 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 since our inception through 2008. For the years ended December 31, 2007 and 2008 we had net losses of approximately $5.4 million and $8.1 million, respectively, and for the year ended December 31, 2009, we had net income of $2.7 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, we may not be able to continue to be profitable. . Through December 31, 2009, we had an accumulated deficit of approximately $23.9 million. We have been, and expect to remain for the foreseeable future, mostly in a research and development stage. We have incurred substantial research and development expenses, which were approximately $7.4 million, $9.6 million and $7.3 million for the years ended December 31, 2007, 2008 and 2009, respectively. 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 do not expect any of our current product candidates to be commercialized within the next several years, if at all. We expect to incur substantial losses for the foreseeable future, and we may never achieve or maintain sustained profitability. We anticipate that our expenses 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 our product candidates, 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 very limited data on the use of our products in humans and will need to perform costly and time consuming clinical trials in order to bring our products to market.

Most of the data that we have on our products is from in-vitro (laboratory) studies or in-vivo animal studies and our human data is from Phase I safety studies or small-scale Phase IIa exploratory- studies. We will need to conduct Phase I, II and III human clinical trials to confirm such results in order to obtain approval from the FDA of our drug product candidates. Often, positive in-vitro or in-vivo animal studies are not followed by positive results in human clinical trials, and we may not be able to demonstrate that our products arc safe and effective for indicated uses in humans. In addition, for each indication, we estimate that it will take between three and five years to conduct the necessary clinical trials.

We currently do not have any marketable products, and if we are unable to develop and obtain regulatory approval for products that we develop, we may never generate product revenues.

To date, our revenues have been derived solely from research and development collaboration and license agreements. We have never generated revenues from sales of products and we cannot guarantee that we will ever have marketable drugs or other products. 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. Before proceeding with clinical trials, we will conduct pre-clinical studies, which may, or may not be, valid predictors of potential outcomes in humans. If pre-clinical studies are favorable, we will then begin clinical trials. 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 products will be derived from sales of products that may not be commercially available for at least the next several years, if at all.

We have limited experience in developing drugs and medical devices, and we may be unable to commercialize any 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 never commercialized, any of our product candidates. 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.

We must maintain and expand expensive finance and accounting systems, procedures and controls in order to grow our business and organization, which will increase our costs and require additional management resources.

We completed our initial public offering, or IPO, in October 2007. As a public reporting company, we are required to comply with the Sarbanes-Oxley Act of 2002 and the related rules and regulations of the SEC and Canadian securities regulatory authorities, including expanded disclosure and accelerated reporting requirements and more complex accounting rules. We are also required to comply with marketplace rules and the heightened corporate governance standards of the NYSE Amex. Compliance with these rules has been expensive, and there are additional rules with which we have not yet needed to comply but which we will need to comply with in the future. For example, for this Form 10-K we are not required to have our independent auditors audit our internal control over financial reporting, but next year we expect to be required to do so. If our independent registered public accounting firm is unable to provide us with an unqualified report as to the effectiveness of our internal control over financial reporting as of the date of our Annual Report on Form 10-K for 2010, or our business grows and we are not able to comply with accelerated reporting obligations, our ability to obtain additional financing could be impaired. In addition, investors could lose confidence in the reliability of our internal control over financial reporting and in the accuracy of our periodic reports filed with the SEC and with Canadian securities regulatory authorities. A lack of investor confidence in the reliability and accuracy of our public reporting could cause our stock price to decline.

Our current research collaborations with Alcon and Galderma may fail, and entering into additional collaborations may not happen, resulting in a decrease in funding and inhibition of our ability to continue developing products.

We have entered into a collaborative arrangement with Alcon, and we rely on Alcon for joint intellectual property creation and for substantially all of our near-term revenues. Under the agreement, we licensed to Alcon the exclusive rights (except for certain retained marketing rights) to develop, manufacture and commercialize products incorporating the Aganocide compounds for application in connection with the eye, ear and sinus and for use in contact lens solutions. We have also 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.

We cannot assure you that our collaborations with Alcon or Galderma or any other collaborative arrangement will be successful, or that we will receive the full amount of research funding, milestone payments or royalties, or that any commercially valuable intellectual property will be created, from these arrangements. If Alcon or 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 plan on entering into additional collaborations and licensing arrangements. We may not be able to negotiate additional collaborations on acceptable terms, if at all, and 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. 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 other products from our research and development activities

Our long-term viability and growth will depend upon the successful development and commercialization of other products 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 the expansion of our pipeline through spending on 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. In order 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 potential products.

We do not currently operate manufacturing facilities for clinical or commercial production of our product NeutroPhase and other product candidates. We have no experience in drug formulation or manufacturing, and we lack the resources and the capabilities to manufacture NeutroPhase or 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 the potential for 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, Chief Scientific Officer, Chief Alliance Officer and Vice President of Product Development, Vice President of Medical Affairs, Vice President of Business and Corporate 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 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 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 United States as well as in other countries. To obtain regulatory approval to market our proposed products outside of the United States, 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 include 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 United States, 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.

In order 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 United States or in other countries.

Our product candidates may be classified as a drug or a medical device, depending on the mechanism of action, 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. Our products may be classified by the FDA as a drug or a medical device depending upon their mechanism of action, indications for use or claims. For example, for NVC-422, if the indication is for bladder lavage, we believe it would be classified as a medical device, whereas we believe it would be considered a drug when it is indicated for the prevention of urinary tract infection. Similarly, the use of NVC-101 as a solution for cleansing and debriding wounds is considered a medical device. The determination as to whether a particular indication is considered a drug or a device is based in part upon prior precedent. A reclassification by the FDA of an indication from a device to a drug indication during our development for that indication could have a significant adverse impact due to the more rigorous 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 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 (as further described below), 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 $3 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 nine months of exclusivity as a generic product under the Waxman-Hatch 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 in order 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 attorneys 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 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 trials, 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 United States. 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 United States 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 NVC-101 composition. If a potential competitor introduces a similar method of using NVC-101 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 NVC-101 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 thereunder 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 United States. 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 bacteria develop resistance to Aganocide compounds, our revenues could be significantly reduced.

Based on our understanding of the hypothesis of the mechanism of action of our Aganocide compounds, we do not expect bacteria to be able to develop resistance to Aganocide 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 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 no internal sales, marketing or distribution capabilities. In order to commercialize any product candidates approved by the FDA, we will either have to develop such capabilities internally or collaborate with third parties who can perform these services for us. If we decide to commercialize any products we develop, 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, 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 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 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 shareholders.

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' earning 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 shareholder 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 shareholders have significant voting power and may take actions that may not be in the best interests of our other shareholders.

As of December 31, 2009, our officers and directors collectively controlled approximately 4,158,640 shares of our outstanding common stock (and approximately 5,445,570 shares of our common stock when including options held by them which were exercisable as of or within 60 days of December 31, 2009). Furthermore, as of December 31, 2009, our largest shareholder, a family trust established and controlled by Dr. Ramin Najafi, our Chairman and Chief Executive Officer, beneficially owned 3,128,700 shares or 13.4 % of our outstanding common stock. As a result, Dr. Najafi can significantly influence the management and affairs of our company and most matters requiring shareholder 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 shareholders.

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 articles of incorporation and bylaws and California law, contain provisions that could discourage a third party from making a takeover offer that is beneficial to our shareholders.

Anti-takeover provisions of our amended and restated articles of incorporation, amended and restated bylaws and California law may have the effect of deterring or delaying attempts by our shareholders 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 shareholder nominations and proposals;
- the ability of our Board of Directors to amend our bylaws without shareholder approval; and
- the ability of our Board of Directors to issue up to 5,000,000 shares of preferred stock without shareholder approval upon the terms and conditions and with the rights, privileges and preferences as our Board of Directors may determine.

In addition, as a California corporation, we are subject to California 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 California Corporations Code 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 shareholders 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 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

Our principal executive offices and our research and development and administrative operations are located in Emeryville, California. In total, we lease approximately 18,100 square feet of office space in the facility pursuant to a lease agreement expiring on October 31, 2015.

ITEM 3. LEGAL PROCEEDINGS

We are currently not a party to, nor is our property the subject matter of, any pending or, to our knowledge, contemplated material legal proceedings. From time to time, we may become party to litigation and subject to claims arising in the ordinary course of our business.

ITEM 4. (REMOVED AND RESERVED)

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information

Since October 25, 2007, our common stock has been listed on the NYSE Amex, formerly American Stock Exchange, and the Toronto Stock Exchange (TSX) under the symbol "NBY." Prior to such time, there was no established public trading market for our common stock. On December 31, 2008, we notified the TSX of our intent to voluntarily remove our listing of common stock from the TSX in order to consolidate trading on the NYSE Amex. The following table sets forth, for the periods indicated, the high and low sales prices for our common stock as reported by the NYSE Amex:

	2009		2008	
	High	Low	High	Low
First Quarter	2.95	1.02	2.41	2.15
Second Quarter	3.24	1.95	2.10	2.09
Third Quarter	2.57	1.62	1.70	1.57
Fourth Quarter	2.39	1.63	1.14	1.02

On March 19, 2010, the last reported sale price of our common stock on the NYSE Amex was $2.08.

Holders

As of March 19, 2010, there were approximately 304 holders of record of our common stock. This figure does not reflect persons or entities that hold their stock in nominee or "street" name through various brokerage firms.

Dividend Policy

We have not paid cash dividends on our common stock since our inception. We currently expect to retain earnings primarily for use in the operation and expansion of our business, and therefore, do not anticipate paying any cash dividends in the near future. Any future determination to pay cash dividends will be at the discretion of our Board of Directors and will be dependent upon our financial condition, results of operations, capital requirements, restrictions under any existing indebtedness and other factors the Board of Directors deems relevant.

Performance Graph(1)

The following graph compares our total stockholder returns for the past 26 months to two indices: the Amex Composite Index and the RDG MicroCap Biotechnology Index. The total return for each index assumes the reinvestment of all dividends, if any, paid by companies included in these indices and are calculated as of December 31 of each year.

As a member of the Amex Composite Index, we are required under applicable regulations to use this index as a comparator, and we believe the RDG MicroCap Biotechnology Index is a relevant comparator since it is composed of peer companies in lines-of-business similar to ours.

The stockholder return shown on the graph below is not necessarily indicative of future performance, and we do not make or endorse any predictions as to future stockholder returns.

(1) This section is not “soliciting material,” is not deemed “filed” with the SEC and is not to be incorporated by reference in any of our filings under the Securities Act or the Exchange Act whether made before or after the date hereof and irrespective of any general incorporation language in any such filing.

	10/07	12/07	12/08	12/09
NovaBay Pharmaceuticals, Inc.	100.00	103.84	28.18	56.91
NYSE Amex Composite	100.00	101.45	61.54	83.49
RDG MicroCap Biotechnology	100.00	84.69	39.20	41.48

Purchases of Equity Securities by the Issuer and Affiliated Purchaser

We did not repurchase any of our outstanding equity securities during the most recent quarter covered by this report.

Use of Proceeds from Sales of Registered Securities

On October 24, 2007, a Registration Statement on Form S-1 (File. No. 333-140714) relating to our initial public offering was declared effective by the SEC. The closing was held October 31, 2007. The net proceeds to us from the offering were approximately $17.1 million.

From the effective date of the registration statement until December 31, 2009, we estimate we had used the entire balance of our proceeds as follows: $12.0 million for research and development, $2.0 million for working capital and $3.1 million for other general purposes.

The amounts reflected above included expenditures for: the Phase I and II clinical development of NVC-422 in pre-surgical nasal preparation; pre-clinical, Phase I and initial Phase II studies of NVC-422 in the prevention of catheter associated urinary tract infections; and pre-clinical studies to select among additional indications to be taken into development. These expenditures did not represent a material change from the use of proceeds described in the prospectus related to the offering.

ITEM 6. SELECTED FINANCIAL DATA

The following selected financial information as of and for the dates and periods indicated have been derived from our audited consolidated financial statements. The information set forth below is not necessarily indicative of results of future operations, and should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operation" in Part II, Item 7 of this report and our consolidated financial statements and related notes included elsewhere in this report.

	Year Ended December 31,				
	2005	2006	2007	2008	2009
	(in thousands, except per share data)				
Statements of Operations Data:					
Revenue	$-	$1,533	$5,913	$6,722	$15,684
Operating expenses:					
Research and development	1,952	4,087	7,421	9,595	7,337
General and administrative	1,617	2,972	4,368	5,636	5,607
Total operating expenses	3,569	7,059	11,789	15,231	12,944
Other income (expense), net	106	240	488	397	(36)
Net income (loss) before income taxes	(3,463)	(5,286)	(5,388)	(8,112)	2,704
Provision for income taxes	-	-	(12)	(2)	(7)
Net income (loss) before income taxes	$(3,463)	$(5,286)	$(5,400)	$(8,114)	$2,697
Net income (loss) per share:					
Basic	$(0.71)	$(0.92)	$(0.60)	$(0.38)	$0.12
Diluted	$(0.71)	$(0.92)	$(0.60)	$(0.38)	$0.12
Shares used in per share calculations:					
Basic	4,852	5,715	8,974	21,312	22,404
Diluted	4,852	5,715	8,974	21,312	23,115

	Year Ended December 31,				
	2005	2006	2007	2008	2009
	(in thousands)				
Balance Sheet Data:					
Cash, cash equivalents and short-term investments	$3,212	$11,086	$22,353	$12,099	$10,992
Working capital	2,985	7,926	18,194	8,033	11,568
Total assets	3,562	11,866	23,922	13,969	17,523
Capital lease obligation—current and non-current	-	-	86	49	7
Equipment loan—current and non-current	-	-	716	836	470
Deferred revenue—current and non-current	-	9,167	7,517	4,167	2,167
Convertible notes payable	-	-	-	-	-
Convertible preferred stock	175	192	-	-	-
Common stock and additional paid-in capital	10,869	14,683	32,797	33,933	37,236
Total stockholders' equity	3,252	1,813	14,320	7,345	13,345

ITEM 7. 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 II, Item 8 of this report. This discussion contains forward-looking statements that involve risks and uncertainties. As a result of many factors, such as those set forth under the section entitled "Risk Factors" in Item 1A and elsewhere in this report, our actual results may differ materially from those anticipated in these forward-looking statements.

Overview

We are clinical stage specialty pharmaceutical company engaged in the discovery and development of innovative product candidates for the treatment or prevention of a wide range of non-systemic infections in hospital and non-hospital environments. Many of these infections have become increasingly difficult to treat because of the rapid rise in drug resistance. We have discovered and are developing a class of non-antibiotic anti-infective compounds, which we have named Aganocide compounds. These compounds are based upon small molecules that are naturally generated by white blood cells when defending the body against invading pathogens. We believe that our Aganocide compounds could form a platform on which to create a variety of products to address differing needs in the treatment and prevention of bacterial and viral infections. In laboratory testing, our Aganocide compounds have demonstrated the ability to destroy all bacteria against which they have been tested. Furthermore, because of their mechanism of action, we believe that bacteria are unlikely to develop resistance to our Aganocide compounds.

In August 2006, we entered into a collaboration and license agreement with Alcon Manufacturing Ltd. ("Alcon"),, to license to Alcon the exclusive rights to develop, manufacture and commercialize products incorporating the Aganocide compounds for application in connection with the eye, ear and sinus and for use in contact lens care. Under the terms of the agreement, Alcon paid an up-front, non-refundable, non-creditable technology access fee of $10.0 million upon the effective date of the agreement. In addition to the technology access fee, we are entitled to receive semi-annual payments from Alcon to support on-going research and development activities over the four year funding term of the agreement. The research and development support payments include amounts to fund a specified number of personnel engaged in collaboration activities and to reimburse for qualified equipment, materials and contract study costs. As product candidates are developed and proceed through clinical trials and approval, we will receive milestone payments. If the products are commercialized, we will also receive royalties on any sales of products containing the Aganocide compounds. Alcon has the right to terminate the agreement in its entirety upon nine months' notice, or terminate portions of the agreement upon 135 days' notice, subject to certain provisions. Both parties have the right to terminate the agreement for breach upon 60 days' notice. In addition, NovaBay retains the rights to market, via a third-party co-marketing partner, any products developed for ear or sinus indications in the major Asian markets, including Japan, China, India and South Korea. NovaBay has also retained such rights in other markets where Alcon is not committing reasonably sufficient sales and marketing resources to the particular product. In each instance, the appointment of the co-marketing partner would be subject to certain conditions, including that the co-marketing partner be approved by Alcon. The co-marketing partner, or NovaBay on its behalf, would be required to pay Alcon a royalty based on net sales of the product in the applicable market and would also be required to reimburse Alcon for part of its local development costs or, in markets in which Alcon is not committing reasonably sufficient sales and marketing resources, all of its local development costs. These products may also be marketed in those markets by Alcon, its affiliates or distributors.

Alcon is responsible for all of the costs that it incurs in developing the products using the Aganocide compounds. We recently announced that Alcon has increased its on-going financial support of the company's research and development efforts by more than $2 million per year. The additional funding is expected to enhance NovaBay's pre-clinical and clinical development programs in the areas of eye, ear and sinus infections, as well as contact lens solutions. Alcon is

conducting Phase II trials of NovaBay's lead compound, NVC-422, for the treatment of viral conjunctivitis, a type of "Pink Eye". The viral conjunctivitis trials are under way at 30 medical centers around the U.S. and expect to enroll approximately 250 patients. The achievement of the milestones and product commercialization is subject to many risks and uncertainties, including, but not limited to Alcon's ability to obtain regulatory approval from the FDA and Alcon's ability to execute its clinical initiatives. Therefore, we cannot predict when, if ever, the milestones specified in the Alcon agreement will be achieved or when we will receive royalties on sales of commercialized product.

On March 25, 2009, we announced that we 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. We amended this agreement in December 2009. The agreement is exclusive and worldwide in scope, with the exception of Asian markets and North America. In Asian markets we have commercialization rights. In North America we have an option to exercise co-promotion rights.

Galderma will be responsible for the development costs of the acne and other indications with two exceptions. First, in Japan Galderma has the option to request that we share such development costs. Second, at this time we are supporting the ongoing development program for impetigo; however, upon the achievement of a specified milestone, Galderma will reimburse NovaBay for associated expenses. NovaBay retains the right to co-market products resulting from the agreement in Japan. In addition, NovaBay has retained all rights in other Asian markets outside Japan, and has the right to co-promote the products developed under the agreement in the hospital and other healthcare institutions in North America.

Galderma paid to NovaBay certain upfront fees at the inception of the contract and will continue to pay 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. Upon the termination of the agreement under certain circumstances, Galderma will grant NovaBay certain technology licenses which would require NovaBay to make royalty payments to Galderma for such licenses with royalty rates in the low- to mid-single digits.

We recently announced that we received $3.75 million in milestone payments from Galderma; a $2.0 million milestone payment having been triggered by the completion of formulation feasibility studies with our Aganocide compound for topical use, and a $1.75 million milestone payment was for completing an exploratory clinical study for the treatment of adult acne. These milestones were reached in 2009 and therefore the revenue was recorded in 2009 and the related receivable is included in our balance sheet as of December 31, 2009; we received payment on these receivables in January 2010.

Our business model is to develop our Aganocide compounds and enter into collaboration and license agreements with other entities for different indications using our Aganocide compounds. For example, in June 2007, we entered into a license agreement with KCI, under which KCI paid to us a non-refundable technology access fee of $200,000. The agreement was terminated in November 2009. If products covered by the license had been commercially launched, we would also have received royalty payments based on net revenues from sales by KCI of such products. We did not receive any milestone or other payments under this agreement since the initial technology access fee.

To date, we have generated no 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 Alcon and Galderma. We are a development stage company and have incurred significant losses since commencement of our operations in July 2002, as we have devoted substantially all of our resources to research and development. As of December 31, 2009, we had an accumulated deficit of $23.9 million. Our accumulated deficit resulted from research and development expenses and general and administrative expenses. Although we were profitable in 2009, 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.

Significant Events in 2009 and 2010

In January 2009, the FDA accepted the Investigational New Drug application (IND) submitted by Alcon to permit the clinical development of our NVC-422 for infections of the eye. The IND clearance triggered the immediate payment of the first milestone of $1.0 million from Alcon.

On January 9, 2009, we announced that the United States Patent and Trademark Office has approved the issuance of a patent for novel Aganocide compounds, including our current lead compound, NVC-422.

On March 7, 2009, we announced preclinical animal data showing that NVC-422, our lead Aganocide compound, is effective in treating topical fungal infections.

On March 25, 2009, we announced that it has entered into an agreement with Galderma S.A. to develop and commercialize our novel proprietary Aganocide compounds. We amended this agreement in December 2009. The exclusive agreement is worldwide in scope, except in certain Asian markets, where we have commercialization rights, and North America, where we have an option to exercise co-promotion rights, and covers acne and impetigo and potentially other major dermatological conditions, excluding onychomycosis (nail fungus) and orphan drug indications.

On April 22, 2009 we announced an exclusive agreement with Professors Markus Nagl M.D. and Waldemar Gottardi, Ph.D. of the Medical University of Innsbruck, Austria. The agreement was entered into to advance the development of NovaBay's Aganocide® compounds by integrating extensive and on-going clinical work at the university with NovaBay's development program.

On August 26, 2009, we closed a registered direct offering of 1,225,000 units, with each unit consisting of (i) one share of the NovaBay common stock, par value $0.01 per share, and (ii) one warrant to purchase one share of NovaBay common stock. The purchase price for each unit was $2.00. Each warrant has an exercise price of $2.75 and will expire five years from the date of issuance. Neither the units nor warrants trade on any exchange or are listed for quotation on any market.

In July 2009, we announced that Alcon has begun treating patients in a Phase II clinical trial of NovaBay's patented lead Aganocide compound, NVC-422, for viral conjunctivitis, a type of "pink eye."

In September 2009, we announced that we initiated our Phase IIa proof-of-concept study for the treatment of impetigo.

In October 2009, we announced that our Aganocides show penetration and efficacy in a pre-clinical infected human nail model of Onychomycosis. This data was presented at the 47th Annual Meeting of the Infectious Diseases Society of America (IDSA) in Philadelphia.

In December 2009, we announced that Alcon has increased its on-going financial support of the company's research and development efforts by more than $2 million per year. The additional funding is expected to enhance NovaBay's pre-clinical and clinical development programs in the areas of eye, ear and sinus infections, as well as contact lens solutions.

In January 2010, we announced that we received $3.75 million in milestone payments from Galderma, a $2 million milestone payment having been triggered by the completion of formulation feasibility studies with our Aganocide compounds for topical use and a $1.75 million milestone payment for completing an exploratory clinical study for the treatment of adult acne. Both of these studies were concluded in 2009 and the resulting revenues were recorded in our 2009 results.

Critical Accounting Policies and Estimates

Our financial statements have been prepared in accordance with accounting principles generally accepted in the United States (US GAAP). The preparation of these 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 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.

While our significant accounting policies are more fully described in Note 2 of the Notes to Consolidated Financial Statements, included in Part II, Item 8 of this report, we believe that the following accounting policies are most critical to fully understanding and evaluating our reported financial results.

Revenue Recognition

License and collaboration revenue is primarily generated through agreements with strategic partners for the development and commercialization of our 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 authoritative guidance, we analyze our multiple element arrangements to determine whether the elements can be separated. We perform our 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 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 collectibility is reasonably assured. If these factors were to vary the resulting change could have a material effect on our revenue recognition and on our results of operations.

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

Upfront Fees—We defer recognition of non-refundable upfront fees if we have continuing performance obligations without which the technology licensed has no utility to the licensee. If we have continuing involvement through research and development services that are required because our know-how and expertise related to the technology is proprietary to us, or can only be performed by us, then such up-front fees are deferred and recognized over the

estimated period of continuing involvement. We base the estimate of the period of continuing involvement on factors in the contract. Actual time frames could vary and could result in material changes to our 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. The full-time equivalent amount can vary each year if the contracts allow for a percentage increase determined by relevant salary surveys, if applicable. 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—We recognize royalty revenues from licensed products upon the sale of the related products.

Research and Development Costs

We charge 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. Research and development costs may vary depending on the type of item or service incurred, location of performance or production, or lack of availability of the item or service, and specificity required in production for certain compounds. We use 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. Our on-going research, clinical and development activities are often performed under agreements we enter into with external service providers. We accrue the costs incurred under these agreements based on factors such as milestones achieved, patient enrollment, estimates of work performed, and historical data for similar arrangements. As actual costs are incurred we will adjust our accruals. Historically, our accruals have been consistent with management's estimates, and no material adjustments to research and development expenses have been recognized. Subsequent changes in estimates may result in a material change in our expenses, which could also materially affect our results of operations.

Patent Costs

We expense patent costs, including legal expenses, in the period in which they are incurred. Patent expenses are included as general and administrative expenses in our statements of operations. Patent costs may vary depending on the location, domestic or foreign, in which the patent is being secured.

Stock-Based Compensation

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. Forfeitures are estimated at the time of grant and reduce compensation expense ratably over the vesting period. This estimate is adjusted periodically based on the extent to which actual forfeitures differ, or are expected to differ, from the previous estimate. See Note 10 for further information regarding stock-based compensation expense and the assumptions used in estimating that expense. For stock options granted to employees, the fair value of the stock options is estimated using a Black-Scholes-Merton valuation model.

Stock compensation arrangements with non-employees are recorded at their fair value on the measurement date. The measurement of stock-based compensation is subject to periodic adjustment as the underlying equity instruments vest. Non-employee stock-based compensation charges are amortized over the vesting period on a straight-line basis. For stock options granted to non-employees, the fair value of the stock options is estimated using a Black-Scholes-Merton valuation model.

Income Taxes

We account 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 all of the deferred tax asset will not be recognized. Valuation allowances are based, in part, on estimates that management must make as to our results in

future periods. The actual outcome may not be consistent with our estimate, which would require that we make changes in our valuation allowance.

Recent Accounting Pronouncements

During the third quarter of 2009, we adopted the FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles in accordance with FASB ASC Topic 105,"Generally Accepted Accounting Principles"(the Codification). The Codification has become the source of authoritative U.S. generally accepted accounting principles (GAAP) recognized by the FASB to be applied by nongovernmental entities. Rules and interpretive releases of the Securities and Exchange Commission (SEC) under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. Effective with our adoption on July 1, 2009, the Codification has superseded all prior non-SEC accounting and reporting standards. All other non-grandfathered non-SEC accounting literature not included in the Codification has become non-authoritative. As the adoption of the Codification only affected how specific references to GAAP literature have been disclosed in the notes to our condensed consolidated financial statements, it did not result in any impact on our results of operations, financial condition, or cash flows.

In September 2009, the FASB issued authoritative guidance regarding multiple-deliverable revenue arrangements. This guidance addresses how to separate deliverables and how to measure and allocate consideration to one or more units of accounting. Specifically, the guidance requires that consideration be allocated among multiple deliverables based on relative selling prices. The guidance establishes a selling price hierarchy of (1) vendor-specific objective evidence, (2) third-party evidence and (3) estimated selling price. This guidance is effective for annual periods beginning after June 15, 2010 but may be early adopted as of the beginning of an annual period. We are currently evaluating the effect that this guidance will have on our consolidated financial position and results of operations.

ASC 855-10-20, "Subsequent Events" establishes accounting and reporting standards for events that occur after the balance sheet date but before financial statements are issued or are available to be issued and requires the disclosure of the date through which a company has evaluated subsequent events. This statement was effective for our third quarter ended September 30, 2009 and the adoption did not have an impact on our condensed consolidated financial statements. See Note 13 for the required disclosures.

In April 2009, the FASB issued ASC 820-10-65 formerly FASB Staff Position FAS 157-4, "Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly" ("FSP 157-4"). This provides significant guidance for determining when a market has become inactive as well as guidance for determining whether transactions are not orderly. It also provides guidance on the use of valuation techniques and the use of broker quotes and pricing services. It reiterates that fair value is based on an exit price and also that fair value is market-driven and not entity-specific. The accounting standard of codification applies to all assets and liabilities within the scope of ASC 820 and is effective for all interim and annual periods ending after June 15, 2009. The adoption of ASC 820-10-65 did not have a material effect on our results of operations, financial position, and cash flows.

In April 2009, the FASB issued ASC 320-10-65, formerly FASB Staff Position FAS 115-2, FAS 124-2 and EITF 99-20-2, "Recognition and Presentation of Other-Than-Temporary Impairments" ("FSP 115-2"). This accounting standard provides guidance related to determining the amount of an other-than-temporary impairment (OTTI) of debt securities and prescribes the method to be used to present information about an OTTI in the financial statements. It is effective for all interim and annual periods ending after June 15, 2009. The adoption of ASC 320-10-65 did not have a material effect on our results of operations, financial position, and cash flows.

In April 2009, the FASB issued ASC 825-10-65, formerly FASB Staff Position FAS 107-1 and APB 28-1, "Interim Disclosures about Fair Value of Financial Instruments" ("FSP 107-1"), which increases the frequency of fair value disclosures to a quarterly basis instead of an annual basis. The guidance relates to fair value disclosures for any financial instruments that are not currently reflected on the balance sheet at fair value. This ASC is effective for interim and annual periods ending after June 15, 2009. The adoption of ASC 825-10-65 did not have a material effect on our results of operations, financial position, and cash flows.

Results of Operations

Comparison of Years Ended December 31, 2009, 2008 and 2007

License and Collaboration Revenue

Total license and collaboration revenue was $15.7 million for the year ended December 31, 2009, compared to $6.7 million for the year ended December 31, 2008, and $5.9 million for the year ended December 31, 2007.

On March 25, 2009, we entered into the agreement with Galderma. Under the terms of this agreement Galderma will pay to NovaBay certain upfront fees, ongoing fees, reimbursements, and milestone payments related to achieving

development and commercialization of its Aganocide compounds. We received an upfront technology access fee from Galderma of $1 million, which is being amortized into revenue over the term of the contract. During 2009, $0.5 million of the upfront technology access fee was recognized. We also recognized $1.2 million in ongoing research and development fees and $4.8 million in materials, equipment and contract study costs, which includes the $3.75 million milestone payment from Galderma earned in December 2009.

In August 2006, we entered into the collaboration and license agreement with Alcon. The upfront technology access fee of $10.0 million from Alcon is being amortized into revenue on a straight-line basis over the four year funding term of the agreement, through August 2010. During 2009, $2.5 million of the upfront technology access fee was recognized. We also recognized $5.3 million in ongoing research and development fees and $1.3 million in materials, equipment and contract study costs. During 2008, $2.5 million of the upfront technology access fee was recognized, and we recognized $2.7 million in ongoing research and development fees and $1.4 million in materials, equipment and contract study costs. During 2007, $2.5 million of the upfront technology access fee was recognized, and we recognized $2.7 million in ongoing research and development fees and $611,000 in materials, equipment and contract study costs.

Research and Development

Total research and development expenses decreased by 24% to $7.3 million for the year ended December 31, 2009 from $9.6 million for the year ended December 31, 2008. This decrease was primarily due to the following:

- a decrease in clinical costs of $1.7 million resulting from lower costs related to our trials in 2009;
- a decrease in employee costs of $0.5 million resulting from staffing cuts in late 2008; and
- a decrease of $0.3 million in development costs due to reduced process development activites;

These decreases were partially offset by an increase in professional fees of $0.2 million and an increase of $0.1 million in research costs due to additional contract study costs.

Total research and development expenses increased by 29% to $9.6 million for the year ended December 31, 2008 from $7.4 million for the year ended December 31, 2007. This increase was due in part to an increase in related employee costs of $0.5 million, as the average number of research and development personnel increased for most of 2008. In addition, research expenses increased by 26% to $0.6 million as a result of increased contract studies in bio-sciences and discovery research, and an increase in related lab services and supplies, and development expenses increased by 92% to $1.4 million, mainly due to an increase in process development, method development, and formulation studies. In addition, $0.7 million of overhead expenses were allocated to research and development.

We expect to incur increasing research and development expenses in 2010 and in subsequent years as we continue to increase our focus on developing product candidates, both independently and in collaboration with Alcon and Galderma. In particular, we expect to incur ongoing clinical, chemistry, and manufacturing expenses during 2010 in connection with the common cold, dermatology, and catheter associated urinary tract infections programs.

General and Administrative

General and administrative expenses in 2009 and 2008 were $5.6 million, compared to $4.4 million for the year ended December 31, 2007. This increase from 2007 was due in part to an increase in employee costs of 53%, to $2.5 million. The increase in employee costs was mainly due to a 53% increase in salaries and wages to $1.4 million and related increases in other employee benefits and recruiting expenses, due primarily to increased headcount.

We expect that general and administrative expenses will increase during 2010 and in subsequent years due to increasing public company expenses and business development costs and our expanding operational infrastructure. In particular, we expect to incur increasing legal, accounting, investor relations, equity administration and insurance costs in order to continue operations as a public company.

Other Income(expense), Net

Other income (expense), net decreased to an expense of $36,000 for the year ended December 31, 2009 from an income of $397,000 for the year ended December 31, 2008 and an income of $488,000 for the year ended December 31, 2007. The decrease in 2009 was primarily attributable to decreased interest income related to decreased average investment balances and decreased interest rates throughout the year. Interest income relates primarily to interest earned on cash, cash equivalents and investments in marketable securities.

The decrease in 2008 was primarily attributable to increased interest expense related to borrowings secured by capital equipment, due to paying interest for the full year instead of a partial year. The 2008 decrease was also attributed to increased finance and service charges related to increased borrowings on the line of credit secured by the capital equipment loan.

We expect that other income, net will vary based on fluctuations in our cash balances and borrowings under equipment loans and the interest rate paid on such balances and borrowings.

Liquidity and Capital Resources

We have incurred cumulative net losses of $23.9 million since inception through December 31, 2009. We do not expect to generate significant revenue from product candidates for several years. Since inception, we have funded our operations primarily through the private placement of our preferred stock. We raised total net proceeds of $12.6 million from sales of our preferred stock in 2002 through 2006. In October 2007, we completed our IPO in which we raised a total of $20.0 million, or approximately $17.1 million in net cash proceeds after deducting underwriting discounts and commissions of $1.4 million and other offering costs of $1.5 million. In August 2009, we completed a registered direct offering and had net proceeds of $1.9 million.

In August 2006, we entered into a collaboration and license agreement with Alcon. Under the terms of this agreement, we received an up-front technology access fee of $10.0 million in September 2006. Additionally, we are entitled to receive semi-annual payments each January and July over the four year term of the agreement to support on-going research and development efforts. In both January and July 2007, we received a payment of $1.4 million to support the performance of research and development activities throughout 2007. The Alcon agreement also provides for milestone payments upon the achievement of specified milestones in each field of use and royalty payments upon the sale of commercialized products. The aggregate milestone payments payable in connection with the ophthalmic, otic and sinus fields are $19 million, $12 million and $39 million, respectively. As of December 31, 2009, we have achieved our first milestone under this agreement, but product has not been commercialized to date. The achievement of the milestones and product commercialization is subject to many risks and uncertainties, including, but not limited to Alcon’s ability to obtain regulatory approval from the FDA and Alcon’s ability to execute its clinical initiatives. Therefore, we cannot predict when, if ever, the remaining milestones specified in the Alcon agreement will be achieved or when we will receive royalties on sales of commercialized products.

During April 2007, we entered into a master security agreement to establish a $1.0 million equipment loan facility with a financial institution. The purpose of the loan is to finance equipment purchases, principally in the build-out of our laboratory facilities. Borrowings under the loan are secured by eligible equipment purchased from January 2006 through April 2008 and will be repaid over 40 months at an interest rate equal to the greater of 5.94% over the three year Treasury rate in effect at the time of funding or 10.45%. There are no loan covenants specified in the agreement. As of December 31, 2009, we had an outstanding equipment loan balance of $470,000 carrying a weighted-average interest rate of 10.99%. The principal and interest due under the loan will be repaid in equal monthly installments through April 2011. As of December 31, 2009 there was $216,000 available for borrowing under this equipment loan facility.

In March 2009, we entered into a license agreement with Galderma. We amended this agreement in December 2009. Under the terms of the agreement, we received an initial upfront payment. In addition, in December 2009, we recorded revenues of $3.75 million related to milestones from Galderma S.A. These milestones consist of $2 million having been triggered by the completion of formulation feasibility studies with our Aganocide compounds for topical use and $1.75 million was for completing an exploratory clinical study for the treatment of adult acne. In addition, Galderma will pay to NovaBay certain upfront fees, ongoing fees, reimbursements, and additional milestone payments related to achieving development and commercialization of its Aganocide compounds

Cash and Cash Equivalents

As of December 31, 2009, we had cash, cash equivalents, and short-term investments of $11.3 million compared to $12.1 million and $22.4 million at December 31, 2008 and 2007, respectively.

Cash Used in Operating Activities

For the years ended December 31, 2009 and 2008, cash used in operating activities of $1.6 million and $9.9 million, respectively, was primarily attributable to our research and development and general administrative expenses in running our company. The decrease in 2009 of cash used in operating activities is primarily due to our decreases in research and development expenses as discussed above, and to our collection of ongoing research and development fees from Alcon and the addition of the Galderma contract in 2009.

For the year ended December 31, 2007, cash used in operating activities of $6.3 million, was primarily attributable to our research and development and general administrative expenses in running our company, and lack of any meaningful cash inflow, as the revenue we recognized was primarily related to amortization of the $10.0 million upfront technology access fee received from Alcon in 2006.

Cash Provided by (Used in) Investing Activities

For the year ended December 31, 2009, cash used by investing activities of $1.1 million was attributable to purchases of short-term investments (net of sales) of $340,000 and purchases of property and equipment of $731,000.

For the year ended December 31, 2008, cash provided by investing activities of $10.9 million was attributable to sales of short-term investments (net of purchases) of $11.5 million and purchases of property and equipment of $610,000.

For the year ended December 31, 2007, cash used in investing activities of $5.7 million was attributable to purchases of short-term investments (net of maturities or sales) of $5.0 million and purchases of property and equipment of $663,000.

Cash Provided by Financing Activities

Net cash provided by financing activities of $1.6 million for the year ended December 31, 2009 was primarily attributable to the $1.9 million received through our shelf offering, partially offset by principle payments on our equipment loan.

Net cash provided by financing activities of $236,000 for the year ended December 31, 2008 was primarily attributable to the $422,000 increase in proceeds from borrowings under our equipment loan, net of payments on the outstanding balance.

Net cash provided by financing activities of $18.0 million for the year ended December 31, 2007 was primarily attributable to the net proceeds of $17.1 million received upon the close of the IPO and $794,000 in proceeds from borrowings under our equipment loan.

Quarterly Results of Operations

The following table presents unaudited quarterly results of operations for the eight most recent quarters ending with the quarter ended December 31, 2009. This information has been derived from our unaudited financial statements and has been prepared by us on a basis consistent with our audited annual financial statements and includes all adjustments, consisting only of normal recurring adjustments, which management considers necessary for a fair presentation of the information for the periods presented.

	Quarter Ended							
	March 31, 2008	June 30, 2008	Sept. 30, 2008	Dec. 31, 2008	March 31, 2009	June 30, 2009	Sept. 30, 2009	Dec. 31, 2009
	(in thousands, except per share data)							
Statements of Operations Data:								
Revenue	$1,492	$1,442	$1,592	$2,196	$2,611	$2,357	$3,224	$7,492
Operating expenses:								
Research and development	2,762	2,307	1,599	2,927	1,361	1,444	2,004	2,528
General and administrative	1,569	1,640	1,559	868	1,579	1,191	1,309	1,528
Total operating expenses	4,331	3,947	3,158	3,795	2,940	2,635	3,313	4,056
Other income (expense), net	163	94	77	63	11	(11)	(22)	(14)
Net income (loss) before income taxes	(2,676)	(2,411)	(1,489)	(1,536)	(318)	(289)	(111)	3,422
Provision for income taxes	(2)	-	-	-	-	-	-	(7)
Net income (loss) after income taxes	$(2,678)	$(2,411)	$(1,489)	$(1,536)	$(318)	$(289)	$(111)	$3,415
Net income (loss) per share:								
Basic	$(0.13)	$(0.11)	$(0.07)	$(0.07)	$(0.01)	$(0.01)	$(0.00)	$0.15
Diluted	$(0.13)	$(0.11)	$(0.07)	$(0.07)	$(0.01)	$(0.01)	$(0.00)	$0.14
Shares used in per share calculations:								
Basic	21,288	21,334	21,443	21,469	21,620	21,931	23,251	23,253
Diluted	21,288	21,334	21,443	21,469	21,620	21,931	23,251	23,935

Net Operating Losses and Tax Credit Carryforwards

As of December 31, 2009 we had net operating loss carryforwards for both federal and state income tax purposes of $20 million. If not utilized, the federal and state net operating loss carryforwards will begin expiring at various dates between 2016 and 2029.

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 contractual cash commitments as of December 31, 2009 were as follows (in thousands):

Contractual Obligations	Total	Less Than 1year	1 - 3 Years	3 - 5 Years	More Than 5 Years
Operating leases	$5,410	$901	$1,914	$2,007	$588
Captial lease	7	7	-	-	-
Equipment loan	505	396	109	-	-
	$5,922	$1,304	$2,023	$2,007	$588

Our commitments under the operating leases shown above consist of payments relating to our lease of laboratory and office space in one office building in Emeryville, California. This lease expires on October 31, 2015.

Our commitment under the capital lease shown above consists of the total payments due under one lease of laboratory equipment. This amount includes an immaterial amount of interest payments over the remaining term of the lease.

Our commitment under the equipment loan shown above consists of the total payments due under the loan facility. This amount includes approximately $35,000 of interest payments over the remaining term of the loan.

We believe our cash balance at December 31, 2009 is sufficient to fund our projected operating requirements through at least the next twelve months. However, we will need to raise additional capital or incur indebtedness to continue to fund our operations in the future. Our future capital requirements will depend on many factors, including:

- 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 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 anticipate that we will generate significant product revenue for a number of years. Until we can generate a sufficient amount of product revenue, if ever, we expect to finance future cash needs through public or private equity offerings, debt financings or corporate collaboration and licensing arrangements, as well as through interest income earned on cash balances and short-term investments. To the extent that we raise additional funds by issuing equity securities, our shareholders may experience dilution. In addition, debt financing, if available, may involve restrictive covenants. To the extent that we raise additional funds through collaboration and licensing arrangements, it may be necessary to relinquish some rights to our technologies or product candidates, or grant licenses on terms that are not

favorable to us. If adequate funds are not available, we may be required to delay, reduce the scope of or eliminate one or more of our research or development programs or to obtain funds through collaborations for some of our technologies or product candidates that we would otherwise seek to develop on our own. Such collaborations may not be on favorable terms or they may require us to relinquish rights to our technologies or product candidates.

ITEM 7A. 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 December 31, 2009 and 2008, a 10% change in interest rates would have had an immaterial affect 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. We have recently formed a wholly-owned subsidiary, which is incorporated under the laws of British Columbia (Canada), which may conduct research and development activities in Canada. To the extent we conduct operations in Canada, fluctuations in the exchange rates of the U.S. and Canadian currencies may affect our operating results.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The financial statements required by this Item 8 are set forth below. Our quarterly financial information is set forth in Item 7 of this report and is hereby incorporated into this Item 8 by reference.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

REPORT OF INDEPENDENT REGISTERED
PUBLIC ACCOUNTING FIRM

To the Stockholders and the Board of Directors of
NovaBay Pharmaceuticals Inc. (a development stage company)

We have audited the accompanying consolidated balance sheets of NovaBay Pharmaceuticals Inc. (a development stage company) as at December 31, 2009 and 2008 and the related consolidated statements of operations, stockholders' equity and cash flows for the years ended December 31, 2009, 2008, 2007, and for the period from July 1, 2002 (date of development stage inception) to December 31, 2009. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the company’s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as at December 31, 2009 and 2008 and the results of its operations and its cash flows for the years ended December 31, 2009, 2008, 2007, and for the period from July 1, 2002 (date of development stage inception) to December 31, 2009 in conformity with generally accepted accounting principles in the United States of America.

/s/ Davidson & Company LLP
Chartered Accountants

Vancouver, Canada
March 26, 2010

NOVABAY PHARMACEUTICALS, INC.
(a development stage company)
CONSOLIDATED BALANCE SHEETS
(in thousands, except per share data)

	Decmber 31, 2008	December 31, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	$12,099	$10,992
Short-term investments	-	300
Accounts receivable	-	3,801
Prepaid expenses and other current assets	414	513
Total current assets	12,513	15,606
Other Assets	-	105
Property and equipment, net	1,456	1,812
TOTAL ASSETS	$13,969	$17,523
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Current liabilities:		
Accounts payable	$406	$272
Accrued liabilities	1,166	1,228
Capital lease obligation	42	7
Equipment loan	366	364
Deferred revenue	2,500	2,167
Total current liabilities	4,480	4,038
Deferred Tax	-	34
Capital lease obligation - non-current	7	-
Equipment loan - non-current	470	106
Deferred revenue - non-current	1,667	-
Total liabilities	6,624	4,178
Stockholders' Equity:		
Common stock, $0.01 par value; 65,000 shares authorized at December 31, 2009 and December 31, 2008; 23,254 and 21,471 shares issued and outstanding at December 31, 2009 and December 31, 2008, respectively	215	233
Additional paid-in capital	33,718	37,003
Accumulated other comprehensive income (loss)	-	-
Accumulated deficit during development stage	(26,588)	(23,891)
Total stockholders' equity	7,345	13,345
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$13,969	$17,523

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

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NOVABAY PHARMACEUTICALS, INC.
(a development stage company)
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)

	Year Ended December 31,			Cumulative Period from July 1, 2002 (date of development stage inception) to December 31,
	2007	2008	2009	2009
REVENUE				
License and collaboration revenue	$5,913	$6,722	$15,684	$ 29,852
Total revenue	5,913	6,722	15,684	29,852
EXPENSES				
Operating Expenses:				
Research and development	7,421	9,595	7,337	32,344
General and administrative	4,368	5,636	5,607	22,571
Total operating expenses	11,789	15,231	12,944	54,915
Other income (loss), net	488	397	(36)	1,193
Net income (loss) before income taxes	(5,388)	(8,112)	2,704	(23,870)
Provision for income taxes	(12)	(2)	(7)	(21)
Net income (loss) before income taxes	$(5,400)	$(8,114)	$2,697	$ (23,891)
Net income (loss) per share:				
Basic	$(0.60)	$(0.38)	$0.12	
Diluted	$(0.60)	$(0.38)	$0.12	
Shares used in per share calculations:				
Basic	8,974	21,312	22,404	
Diluted	8,974	21,312	23,115	

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

NOVABAY PHARMACEUTICALS, INC.
(a development stage company)
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(in thousands)

	Preferred Stock Shares	Preferred Stock Amount	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Stock Subscription Receivable	Accumulated Other Compre-hensive Income (Loss)	Accumulated Deficit During Development Stage	Total Stockholders' Equity
Balance at July 1, 2002	-	$-	-	$-	$ -	$ -	$ -	$ -	$ -
Comprehensive loss:									
Net loss	-	-	-	-	-	-	-	(544)	(544)
Total comprehensive loss									(544)
Issuance of Series A preferred stock and common stock for acquisition of LLC	2,723	27	3,902	39	462	-	-	-	528
Stock-based compensation expense related to non-employee stock options	-	-	-	-	15	-	-	-	15
Sale of stock warrants	-	-	-	-	10	-	-	-	10
Balance at December 31, 2002	2,723	27	3,902	39	487	-	-	(544)	9
Comprehensive loss:									
Net loss	-	-	-	-	-	-	-	(977)	(977)
Total comprehensive loss									(977)
Issuance of Series A preferred stock	492	5	-	-	192	-	-	-	197
Issuance of Series B preferred stock net of issuance costs of $86	3,258	33	-	-	1,413	-	-	-	1,446
Issuance of stock	-	-	25	-	7	-	-	-	7
Issuance of stock for option exercises	-	-	40	1	7	-	-	-	8
Issuance of stock for warrant exercises	-	-	137	1	109	-	-	-	110
Stock-based compensation expense related to non-employee stock options	-	-	-	-	2	-	-	-	2
	6,473	65	4,104	41	2,217	-	-	(1,521)	802

Balance at December 31, 2003									
Comprehensive loss:									
Net loss	-	-	-	-	-	-	-	(2,804)	(2,804)
Total comprehensive loss									(2,804)
Issuance of Series B preferred stock net of issuance costs of $127	2,694	27	-	-	1,112	-	-	-	1,139
Issuance of Series B preferred stock upon conversion of notes	913	9	-	-	420	-	-	-	429
Issuance of Series C preferred stock net of issuance costs of $123	6,311	63	-	-	5,178	(873)	-	-	4,368
Issuance of stock for option exercises	-	-	5	-	1	-	-	-	1
Issuance of stock for warrant exercises	-	-	31	-	37	-	-	-	37
Issuance of stock for Series B offering costs	-	-	368	4	106	-	-	-	110
Issuance of stock for services	-	-	15	-	4	-	-	-	4
Stock-based compensation expense related to non-employee stock options	-	-	-	-	7	-	-	-	7
Balance at December 31, 2004	16,391	164	4,523	45	9,082	(873)	-	(4,325)	4,093

NOVABAY PHARMACEUTICALS, INC.
(a development stage company)
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY – (Continued)
(in thousands)

	Preferred Stock Shares	Amount	Common Stock Shares	Amount	Additional Paid-In Capital	Stock Subscription Receivable	Accumulated Other Compre-hensive Income (Loss)	Accumulated Deficit During Development Stage	Total Stockholders' Equity
Balance at December 31, 2004	16,391	164	4,523	45	9,082	(873)	-	(4,325)	4,093
Comprehensive loss:									
Net loss	-	-	-	-	-	-	-	(3,463)	(3,463)
Change in unrealized gains (losses) on investments	-	-	-	-	-	-	(4)	-	(4)
Total comprehensive loss									(3,467)
Issuance of Series C preferred stock net of issuance costs of $140	355	4	-	-	158	-	-	-	162
Issuance of Series D preferred stock net of issuance costs of $36	742	7	-	-	1,070	-	-	-	1,077
Issuance of stock for option exercises	-	-	50	-	12	-	-	-	12
Issuance of stock for warrant exercises	-	-	292	3	324	-	-	-	327
Issuance of stock and options for Series C offering costs	-	-	164	2	101	-	-	-	103
Issuance of stock for services	-	-	20	-	17	-	-	-	17
Stock-based compensation expense related to non-employee stock options	-	-	-	-	55	-	-	-	55
Proceeds from stock subscription receivable	-	-	-	-	-	873	-	-	873
Balance at December 31, 2005	17,488	175	5,049	50	10,819	-	(4)	(7,788)	3,252
Comprehensive loss:									

Net loss	-	-	-	-	-	-	-	(5,286)	(5,286)
Change in unrealized gains (losses) on investments	-	-	-	-	-	-	16	-	16
Total comprehensive loss									(5,270)
Stock-based compensation expense									
Issuance of Series D preferred stock net of issuance costs of $114	1,739	17	-	-	2,477	-	-	-	2,494
Issuance of stock for option exercises	-	-	80	1	22	-	-	-	23
Issuance of stock for warrant exercises	-	-	1,148	12	964	-	-	-	976
Issuance of stock and options for Series D offering costs	-	-	31	-	64	-	-	-	64
Issuance of stock for services	-	-	3	-	5	-	-	-	5
Initial public offering costs	-	-	-	-	(93)	-	-	-	(93)
Stock-based compensation expense related to employee and director stock options	-	-	-	-	313	-	-	-	313
Stock-based compensation expense related to non-employee stock options	-	-	-	-	49	-	-	-	49
Balance at December 31, 2006	19,227	192	6,311	63	14,620	-	12	(13,074)	1,813

NOVABAY PHARMACEUTICALS, INC.
(a development stage company)
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY – (Continued)
(in thousands)

	Preferred Stock Shares	Preferred Stock Amount	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Stock Subscription Receivable	Accumulated Other Compre-hensive Income (Loss)	Accumulated Deficit During Development Stage	Total Stockholders' Equity
Balance at December 31, 2006	19,227	192	6,311	63	14,620	-	12	(13,074)	1,813
Comprehensive loss:									
Net loss	-	-	-	-	-	-	-	(5,400)	(5,400)
Change in unrealized gains (losses) on investments	-	-	-	-	-	-	(15)	-	(15)
Total comprehensive loss									(5,415)
Conversion of preferred stock to common stock in connection with IPO	(19,227)	(192)	9,614	96	96	-	-	-	-
Issuance of stock and warrants in connection with IPO, net of offering costs	-	-	5,000	50	17,120	-	-	-	17,170
Issuance of stock for option exercises	-	-	298	3	111	-	-	-	114
Issuance of stock for services	-	-	38	-	92	-	-	-	92
Issuance of stock for director compensation	-	-	8	-	29	-	-	-	29
Stock-based compensation expense related to employee and director stock options	-	-	-	-	399	-	-	-	399
Stock-based compensation expense related to non-employee stock options	-	-	-	-	118	-	-	-	118
Balance at December 31, 2007	-	-	21,269	212	32,585	-	(3)	(18,474)	14,320
Comprehensive loss:									
Net loss	-	-	-	-	-	-	-	(8,114)	(8,114)
Realized gains	-	-	-	-	-	-	35	-	35

Change in unrealized gains (losses) on investments	-	-	-	-	-	-	(32)	-	(32)
Total comprehensive loss									(8,111)
Issuance of warrants					67				67
Issuance of stock for option exercises	-	-	123	1	148	-	-	-	149
Issuance of stock for services	-	-	30	1	84	-	-	-	85
Issuance of stock for director compensation	-	-	49	1	123	-	-	-	124
Stock-based compensation expense related to employee and director stock options	-	-	-	-	721	-	-	-	721
Stock-based compensation expense related to non-employee stock options	-	-	-	-	(11)	-	-	-	(11)
Tax benefit from stock plans	-	-	-	-	1	-	-	-	1
Balance at December 31, 2008	-	-	21,471	215	33,718	-	-	(26,588)	7,345

NOVABAY PHARMACEUTICALS, INC.
(a development stage company)
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY – (Continued)
(in thousands)

	Preferred Stock Shares	Preferred Stock Amount	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Stock Subscription Receivable	Accumulated Other Compre-hensive Income (Loss)	Accumulated Deficit During Development Stage	Total Stockholders' Equity
Balance at December 31, 2008	-	-	21,471	215	33,718	-	-	(26,588)	7,345
Comprehensive loss:									
Net income	-	-	-	-	-	-	-	2,697	2,697
Realized gains	-	-	-	-	-	-	-	-	
Change in unrealized gains (losses) on investments	-	-	-	-	-	-	-	-	-
Total comprehensive loss	-	-	-	-	-	-	-	-	2,697
Issuance of common stock in connection w/shelf offering, net of offering costs	-	-	1,225	12	1,932	-	-	-	1,944
Issuance of stock for option exercises	-	-	119	1	74	-	-	-	75
Issuance of stock for services	-	-	309	4	75	-	-	-	79
Issuance of stock for director compensation	-	-	130	1	217	-	-	-	218
Stock-based compensation expense related to employee and director stock options	-	-	-	-	702	-	-	-	702
Stock-based compensation expense related to non-employee stock options	-	-	-	-	285	-	-	-	285
Tax benefit from stock plans	-	-	-	-	-	-	-	-	-
Balance at December 31, 2009	-	-	23,254	$233	$ 37,003	$ -	$ -	$ (23,891)	$ 13,345

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

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

	Year Ended December 31,			Cumulative Period from July 1, 2002 (date of Development Stage inception) to December 31,
	2007	2008	2009	2009
Cash flows from operating activities:				
Net income (loss)	$(5,400)	$(8,114)	$2,697	$ (23,891)
Adjustments to reconcile net income (loss) to net cash used in operating activities:				
Depreciation and amortization	183	304	373	1,077
Accretion of discount on short-term investments	(246)	(23)	42	(259)
Net realized gain on sales of short-term investments	-	(35)	-	(3)
Loss on disposal of property and equipment	-	-	-	121
Stock-based compensation expense for options issued to employees and directors	428	844	920	2,382
Compensation expense for warrants issued for services	-	67	88	188
Stock-based compensation expense for options and stock issued to non-employees	210	(11)	273	798
Taxes paid by LLC	-	-	-	1
Changes in operating assets and liabilities:				
Increase in accounts receivable	-	-	(3,801)	(3,801)
(Increase) decrease in prepaid expenses and other assets	(193)	88	(204)	(613)
Increase (decrease) in accounts payable and accrued liabilities	397	289	(70)	1,527
Increase (decrease) in deferred revenue	(1,650)	(3,351)	(2,000)	2,166
Increase in deferred tax	-	-	34	34
Net cash used in operating activities	(6,271)	(9,942)	(1,648)	(20,273)
Cash flows from investing activities:				
Purchases of property and equipment	(663)	(610)	(731)	(2,891)
Proceeds from disposal of property and equipment	1	-	2	46
Purchases of short-term investments	(49,197)	(32,097)	(3,975)	(98,519)
Proceeds from maturities and sales of short-term investments	44,199	43,571	3,635	98,482
Cash acquired in purchase of LLC	-	-	-	516
Net cash provided by (used in) investing activities	(5,660)	10,864	(1,069)	(2,366)
Cash flows from financing activities:				
Proceeds from preferred stock issuances, net	-	-	-	11,160
Proceeds from common stock issuances	-	-	-	17

Proceeds from exercise of options and warrants	114	153	74	1,835
Initial public offering costs, net of costs	17,170	-	-	17,077
Proceeds from Shelf offering, net of costs	-	-	1,944	1,944
Proceeds from stock subscription receivable	-	-	-	873
Proceeds from issuance of notes	-	-	-	405
Principal payments on capital lease	(31)	(37)	(42)	(150)
Proceeds from borrowings under equipment loan	794	422	-	1,216
Principal payments on equipment loan	(78)	(302)	(366)	(746)
Net cash provided by financing activities	17,969	236	1,610	33,631
Net increase (decrease) in cash and cash equivalents	6,038	1,158	(1,107)	10,992
Cash and cash equivalents, beginning of period	4,903	10,941	12,099	-
Cash and cash equivalents, end of period	$10,941	$12,099	$10,992	$ 10,992

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

NOVABAY PHARMACEUTICALS, INC.
(a development stage company)
CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)
(in thousands)

	Year Ended December 31,			Cumulative Period from July 1, 2002 (date of Development Stage inception) to December 31,
	2007	2008	2009	2009
Supplemental Disclosure of non cash information				
Interest paid	$34	$102	$77	$ 223
Income taxes paid	$-	$-	$-	$ -
Non-cash financing and investing activities				
Issuance of stock options and warrants for stock option costs	$524	$-	$1,086	$ 1,887
Property and equipment acquired under capital lease obligations	$117	$62	$-	$ 219

NOVABAY PHARMACEUTICALS, INC.
(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. ORGANIZATION

NovaBay Pharmaceuticals, Inc. (the "Company") is a clinical stage specialty pharmaceutical company engaged in the discovery and development of innovative product candidates for the treatment or prevention of a wide range of infections in hospital and non-hospital environments. Many of these infections have become increasingly difficult to treat because of the rapid rise in drug resistance. We have discovered and are developing a class of non-antibiotic anti-infective compounds, which we have named Aganocide compounds. These compounds are based upon small molecules that are naturally generated by white blood cells when defending the body against invading pathogens. We believe that our Aganocide compounds could form a platform on which to create a variety of products to address differing needs in the treatment and prevention of bacterial and viral infections. In laboratory testing, our Aganocide compounds have demonstrated the ability to destroy all bacteria against which they have been tested. Furthermore, because of their mechanism of action, we believe that bacteria are unlikely to develop resistance to our Aganocide compounds.

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 may conduct research and development in Canada, and DermaBay, Inc., a wholly-owned U.S. subsidiary, which may explore and pursue dermatological opportunities. We currently operate in one business segment.

In October 2007, we completed an initial public offering of our common stock ("IPO") in which we sold and issued 5,000,000 shares of our common stock at a price to the public of $4.00 per share. We raised a total of $20.0 million from the IPO, or approximately $17.1 million in net cash proceeds after deducting underwriting discounts and commissions of $1.4 million and other offering costs of $1.5 million. Upon the closing of the IPO, all shares of convertible preferred stock outstanding automatically converted into 9,613,554 shares of common stock. In connection with the IPO, we also issued warrants to the underwriters to purchase an aggregate of 350,000 shares of common stock at an exercise price of $4.00 per share. The warrants were exercisable on or after October 31, 2008 and expire on October 31, 2010.

In August 2009, the Company completed a sale of equity securities from its shelf registration statement ("Shelf Registration Offering") in which the Company sold and issued 1,225,000 units, with each unit consisting of one share of the Company's common stock and a warrant to purchase one share of the Company's common stock. The purchase price for each unit was $2.00. Each warrant has an exercise price of $2.75 per share, and will be exercisable 180 days after issuance and will expire five years from the date of issuance. The shares of common stock and the warrants were immediately separable and were issued separately, but were purchased together in the Shelf Registration Offering. The Company raised a total of $2.5 million from the Shelf Registration Offering, or approximately $ 1.9 million in net proceeds after deducting underwriting commissions of $156,000 and other offering costs of $349,868.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The consolidated financial statements include our accounts and the accounts of our wholly owned subsidiaries. Intercompany transactions and balances have been eliminated. The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States ("U.S. GAAP") and are expressed in U.S. dollars. 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 December 31, 2009, we were still in clinical trials and had not commenced our planned principal operations.

Certain amounts for prior periods have been reclassified to conform to current period presentation.

Principles of Consolidation

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

NOVABAY PHARMACEUTICALS, INC.
(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Reverse Stock Split

On August 10, 2007, we filed an amendment to our articles of incorporation to effect a 1-for-2 reverse stock split of our common stock. All share and per share amounts relating to the common stock, stock options and warrants and the conversion ratios of preferred stock included in the financial statements and footnotes have been restated to reflect the reverse stock split.

Use of Estimates

The preparation of financial statements in accordance with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents and Short-Term Investments

We consider all highly liquid instruments with a stated maturity of three months or less to be cash and cash equivalents. Cash and cash equivalents are stated at cost, which approximate their fair value. As of December 31, 2009, our 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.

We classify all highly liquid investments with a stated maturity of greater than three months as short-term investments. Short-term investments generally consist of United States government, municipal and corporate debt securities. We have classified our short-term investments as available-for-sale. We do 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, we occasionally sell 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, net within the consolidated statements of operations. 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. We maintain 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. We do not believe we are exposed to significant credit risk due to the financial position of the financial institutions in which these deposits are held. Additionally, we have established guidelines regarding diversification and investment maturities, which are designed to maintain safety and liquidity.

During the year ended December 31, 2009 100% of our operating revenues were made up by two partners and 100% of our accounts receivables were made up by one partner. For the years ended December 31, 2007 and 2008 two partners represent 100% of our operating revenues.

Fair Value of Financial Assets and Liabilities

Financial instruments, including cash and cash equivalents and short term investments, accounts payable and accrued liabilities are carried at cost, which management believes approximates fair value due to the short-term nature of these instruments. The fair value of capital lease obligations and equipment loans approximates their carrying amounts as a market rate of interest is attached to their repayment.

The Company measures the fair value of financial assets and liabilities based on GAAP guidance which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. Effective January 1, 2008, the Company adopted the provisions for financial assets and liabilities, as well as for any other assets and liabilities that are carried at fair value on a recurring basis. Effective January 1, 2009, the Company adopted the provisions for non-financial assets and liabilities that are required to be measured at fair value. The adoption of these provisions did not materially impact the Company’s consolidated financial position and results of operations.

NOVABAY PHARMACEUTICALS, INC.
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Under 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)

At December 31, 2009 our cash and short term investments were measured using level one inputs.

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 on the shorter of seven years or the life of 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 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. Should there be impairment in the future, the Company would recognize the amount of the impairment based on the discounted expected future cash flows from the impaired assets. The cash flow estimates would be based on management’s best estimates, using appropriate and customary assumptions and projections at the time.

Accumulated Other Comprehensive Income

Accumulated other comprehensive income consists of unrealized gains and losses on short-term investments classified as available-for-sale.

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 under GAAP, the Company analyzes its multiple element arrangements to determine whether the element 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 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—We defer recognition of non-refundable upfront fees if we have continuing performance obligations without which the technology licensed has no utility to the licensee. If we have continuing involvement through research and development services that are required because our know-how and expertise related to the technology is proprietary to us, or can only be performed by us, then such up-front fees are deferred and recognized over the period of continuing involvement.

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. 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—We recognize royalty revenues from licensed products upon the sale of the related products.

Advertising Costs

There were no advertising costs incurred for any of the periods presented.

Research and Development Costs

We charge 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. We use 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.

Patent Costs

We expense patent costs, including legal expenses, in the period in which they are incurred. Patent expenses are included as general and administrative expenses in our statements of operations.

Stock-Based Compensation

The Company accounts for share-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. The Company was required to utilize the prospective application method, under which prior periods are not revised for comparative purposes. Under the prospective application transition method, non-public entities that previously used the minimum value method of the provisions continue to account for non-vested equity awards outstanding at the date of adoption of the provisions in the same manner as they had been accounted for prior to adoption. The provision specifically prohibits pro forma disclosures for those awards valued using the minimum value method. The valuation and recognition provisions apply to new awards and to awards outstanding as of the adoption date that are subsequently modified. The adoption of these provisions had a material effect on the Company’s financial position and results of operations. See Note 10 for further information regarding stock-based compensation expense and the assumptions used in estimating that expense.

Prior to the adoption of ASC 718, the Company valued its stock-based awards using the minimum value method and provided pro-forma information regarding stock-based compensation and net income required. The Company did not recognize stock-based compensation expense in its consolidated statements of operations for option grants to its employees or directors for the periods prior to its adoption of ASC 718 because the exercise price of options granted was generally equal to the fair market value of the underlying common stock on the date of grant.

The Company accounts for stock compensation arrangements with non-employees in accordance with ASC 718 which require that such equity instruments are recorded at their fair value on the measurement date. The measurement of stock-based compensation is subject to periodic adjustment as the underlying equity instruments vest.

Non-employee stock-based compensation charges are amortized over the vesting period on a straight-line basis. For stock options granted to non-employees, the fair value of the stock options is estimated using a Black-Scholes-Merton valuation model.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Income Taxes

We account 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 all of the deferred tax asset will not be recognized.

Net Income (Loss) per Share

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

Basic EPS is computed by dividing net income (loss) available to common shareholders (numerator) by the weighted average number of common shares outstanding (denominator) during the period. Diluted EPS gives effect to all dilutive potential common shares outstanding during the period including stock options and stock warrants, using the treasury stock method, and convertible preferred stock, 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 if their effect would be anti-dilutive. During 2007 and 2008, there is no difference between basic and diluted net loss per share due to the Company’s net losses. The following table sets forth the reconciliation between basic EPS and diluted EPS:

	Year Ended December 31,		
(in thousands)	2007	2008	2009
Net income (loss)	$(5,400)	$(8,114)	$2,697
Basic shares	8,974	21,312	22,404
Add: shares issued upon assumed exercise of stock options	-	-	711
Diluted shares	8,974	21,312	23,115
Basic EPS	$(0.60)	$(0.38)	$0.12
Diluted EPS	$(0.60)	$(0.38)	$0.12

The following outstanding preferred stock, stock options and stock warrants were excluded from the diluted EPS computation as their effect would have been anti-dilutive:

	Year Ended December 31,		
(in thousands)	2007	2008	2009
Stock options	2,896	3,371	711

Stock warrants	350	650	1,875

Recent Accounting Pronouncements

During the third quarter of 2009, the Company adopted the FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles in accordance with FASB ASC Topic 105,"Generally Accepted Accounting Principles"(the Codification). The Codification has become the source of authoritative U.S. generally accepted accounting principles (GAAP) recognized by the FASB to be applied by nongovernmental entities. Rules and interpretive releases of the Securities and Exchange Commission (SEC) under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. Effective with the Company's adoption on July 1, 2009, the Codification has superseded all prior non-SEC accounting and reporting standards. All other non-grandfathered non-SEC accounting literature not included in the Codification has become non-authoritative. As the adoption of the Codification only affected how specific references to GAAP literature have been disclosed in the notes to our condensed consolidated financial statements, it did not result in any impact on the Company's results of operations, financial condition, or cash flows.

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In September 2009, the FASB issued authoritative guidance regarding multiple-deliverable revenue arrangements. This guidance addresses how to separate deliverables and how to measure and allocate consideration to one or more units of accounting. Specifically, the guidance requires that consideration be allocated among multiple deliverables based on relative selling prices. The guidance establishes a selling price hierarchy of (1) vendor-specific objective evidence, (2) third-party evidence and (3) estimated selling price. This guidance is effective for annual periods beginning after June 15, 2010 but may be early adopted as of the beginning of an annual period. The Company is currently evaluating the effect that this guidance will have on consolidated financial position and results of operations.

ASC 855-10-20, “Subsequent Events” establishes accounting and reporting standards for events that occur after the balance sheet date but before financial statements are issued or are available to be issued. This statement is effective for our third quarter ended September 30, 2009 and the adoption did not have an impact on the condensed consolidated financial statements.

In April 2009, the FASB issued ASC 820-10-65 formerly FASB Staff Position FAS 157-4, “Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly” (“FSP 157-4”). This provides significant guidance for determining when a market has become inactive as well as guidance for determining whether transactions are not orderly. It also provides guidance on the use of valuation techniques and the use of broker quotes and pricing services. It reiterates that fair value is based on an exit price and also that fair value is market-driven and not entity-specific. The accounting standard of codification applies to all assets and liabilities within the scope of ASC 820 and is effective for all interim and annual periods ending after June 15, 2009. The adoption of ASC 820-10-65 did not have a material effect on the Company’s results of operations, financial position, and cash flows.

In April 2009, the FASB issued ASC 320-10-65, formerly FASB Staff Position FAS 115-2, FAS 124-2 and EITF 99-20-2, “Recognition and Presentation of Other-Than-Temporary Impairments” (“FSP 115-2”). This accounting standard provides guidance related to determining the amount of an other-than-temporary impairment (OTTI) of debt securities and prescribes the method to be used to present information about an OTTI in the financial statements. It is effective for all interim and annual periods ending after June 15, 2009. The adoption of FSP 115-2 did not have a material effect on the Company’s results of operations, financial position, and cash flows.

In April 2009, the FASB issued ASC 825-10-65, formerly FASB Staff Position FAS 107-1 and APB 28-1, “Interim Disclosures about Fair Value of Financial Instruments” (“FSP 107-1”), which increases the frequency of fair value disclosures to a quarterly basis instead of an annual basis. The guidance relates to fair value disclosures for any financial instruments that are not currently reflected on the balance sheet at fair value. This ASC is effective for interim and annual periods ending after June 15, 2009. The adoption did not have a material effect on the Company’s results of operations, financial position, and cash flows.

NOTE 3. SHORT-TERM INVESTMENTS

Short-term investments at December 31, 2008 and 2009 consisted of the following:

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	December 31, 2008			
(in thousands)	Amortized Cost	Gross Unrealized/Realized Gains	Gross Unrealized/Realized Losses	Market Value
Corporate bonds	$-	$ -	$ -	$-
U.S. Agencies	-	-	-	-
Municipal Bonds	-	-	-	-
Certificates of Deposit	-	-	-	-
Other Fixed Income	-	-	-	-
	$-	$ -	$ -	$-

	December 31, 2009			
(in thousands)	Amortized Cost	Gross Unrealized/Realized Gains	Gross Unrealized/Realized Losses	Market Value
Corporate bonds	$-	$ -	$ -	$-
U.S. Agencies	-	-	-	-
Municipal Bonds	-	-	-	-
Certificates of Deposit	300	-	-	300
Other Fixed Income	-	-	-	-
	$300	$ -	$ -	$300

Contractual maturities of short-term investments as of December 31, 2008 and 2009 were as follows:

	December 31, 2008	
(in thousands)	Amortized Cost	Market Value
Due in one year or less	$-	$-
Due after 10 years	-	-
Total	$-	$-

	December 31, 2009	
(in thousands)	Amortized Cost	Market Value
Due in one year or less	$300	$300
Due after 10 years	-	-
Total	$300	$300

During the years ended December 31, 2007, 2008, and 2009 we recognized a net realized gain of $0, $35,000 and $0 respectively. For the cumulative period from July 1, 2002 (date of development stage inception) to December 31, 2009, we recognized a net realized gain of $3,000.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

NOTE 4. PROPERTY AND EQUIPMENT

Property and equipment consisted of the following:

(in thousands)	December 31, 2008	December 31, 2009
Office and laboratory equipment	$1,728	$2,430
Furniture and fixtures	113	113
Software	110	133
Leasehold improvement	143	147
Total property and equipment, at cost	2,094	2,823
Less: accumulated depreciation	(638)	(1,011)
Total property and equipment, net	$1,456	$1,812

Depreciation expense was $373,000, $304,000 and $183,000 for the years ended December 31, 2009, 2008 and 2007, respectively and $1,077,000 for the cumulative period from July 1, 2002 (date of development stage inception) to December 31, 2009.

NOTE 5. ACCRUED LIABILITIES

Accrued liabilities consisted of the following:

(in thousands)	December 31, 2008	December 31, 2009
Research and development	$509	$118
Employee payroll and benefits	423	744
Professional fees	182	58
Other	52	308
Total accrued liabilities	$1,166	$1,228

NOTE 6. CAPITAL LEASE OBLIGATION

During the first quarter of 2007, we commenced a lease for a portion of our laboratory equipment. This arrangement is being accounted for as a capital lease. Assets under capital leases that are included in property and equipment are as follows:

(in thousands)	December 31, 2008	December 31, 2009
Office and laboratory equipment	$229	$147
Less: accumulated depreciation	(47)	(80)
Capital lease assets, net	$182	$67

Future minimum lease payments under capital leases were as follows at December 31, 2009:

Lease

(in thousands)	Commitment
Year ending December 31, 2010	$7
Total minimum lease payments	7
Less: amount representing interest	-
Present value of minimum lease payments	$7

NOTE 7. EQUIPMENT LOAN

During April 2007, we entered into a master security agreement to establish a $1.0 million equipment loan facility with a financial institution. The purpose of this loan is to finance equipment purchases, principally in the build-out of our laboratory facilities. Borrowings under the loan are secured by eligible equipment purchased from January 2006 through April 2008 and will be repaid over 40 months at an interest rate equal to the greater of 5.94% over the three year Treasury rate in effect at the time of funding or 10.45%. There are no loan covenants specified in the agreement.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

As of December 31, 2009, we had an outstanding equipment loan balance of $470,000 carrying a weighted-average interest rate of 10.99%. At December 31, 2009, there was $216,000 available for borrowing under this equipment loan facility.

Future minimum loan payments under equipment loans were as follows at December 31, 2009:

(in thousands)	Loan Commitment
Year ending December 31:	
2010	$396
2011	109
Total minimum loan payments	505
Less: amount representing interest	(35)
Present value of minimum loan payments	$470

NOTE 8. COMMITMENTS AND CONTINGENCIES

Operating Leases

We lease laboratory facilities and office space under an operating lease, portions of which expire at various dates through 2015. Rent expense was $526,000, $620,000, and $878,000 for the years ended December 31, 2007, 2008 and 2009, respectively, and $2,820,000 for the cumulative period from July 1, 2002 (date of development stage inception) to December 31, 2009. The future minimum lease payments under non-cancellable operating leases were as follows as of December 31, 2009:

(in thousands)	Lease Commitment
Year ending December 31:	
2010	$901
2011	938
2012	976
2013	1,015
2014	992
thereafter	588
Total lease commitment	$5,410

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 December 31, 2009 that, in the opinion of management, would have a material adverse effect on our financial position, results of operations or cash flows.

NOTE 9. STOCKHOLDERS' EQUITY

Preferred Stock

In 2002 and 2003, the Company issued 3.2 million shares of Series A Convertible Preferred Stock for net proceeds of $647,000. In 2003 and 2004, the Company issued 6.9 million shares of Series B Convertible Preferred Stock for net proceeds of $3.0 million. In 2004 and 2005, the Company issued 6.7 million shares of Series C Convertible Preferred Stock for net proceeds of $5.4 million. In 2005 and 2006, the Company issued 2.5 million shares of Series D Convertible Preferred Stock for net proceeds of $3.6 million. All outstanding shares of convertible preferred stock automatically converted into 9.6 million shares of common stock upon the closing of the Company's IPO in October 2007. In connection with the IPO, the Company amended its articles of incorporation to provide for the issuance of up to 5,000,000 shares of preferred stock in such series and with such rights and preferences as may be approved by the board of directors. As of December 31, 2009, there were no shares of preferred stock outstanding.

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Common Stock

Under the Company's amended articles of incorporation, the Company is authorized to issue 65,000,000 shares of $0.01 par value common stock. Each holder of common stock has the right to one vote but does not have cumulative voting rights. Shares of common stock are not subject to any redemption or sinking fund provisions, nor do they have any preemptive, subscription or conversion rights. Holders of common stock are entitled to receive dividends whenever funds are legally available and when declared by the board of directors, subject to the prior rights of holders of all classes of stock outstanding having priority rights as to dividends. No dividends have been declared or paid as of December 31, 2009.

In August 2007, the Company filed an amendment to its articles of incorporation to effect a 1-for-2 reverse stock split of its common stock. All share and per share amounts relating to the common stock, stock options and warrants and the conversion ratios of preferred stock included in the financial statements and footnotes have been restated to reflect the reverse stock split.

In October 2007, the Company completed an initial public offering of its common stock in which it sold and issued 5,000,000 shares of its common stock at a price to the public of $4.00 per share. The Company raised a total of $20.0 million from the IPO, or approximately $17.1 million in net cash proceeds after deducting underwriting discounts and commissions of $1.4 million and other offering costs of $1.5 million.

In August 2009, the Company sold and issued 1,225,000 units of its common stock at a price of $2.00 per unit from a Shelf Registration Offering. Each unit consisted of one share of the Company's common stock and a warrant to purchase one share of the Company's common stock. The Company raised a total of $2.5 million from the Shelf Registration Offering, or approximately $1.9 million in net proceeds after deducting underwriting commissions of $156,000 and other offering costs of $349,868.

Stock Warrants

Warrants to acquire shares of common stock were issued in connection with the sales of the Series A and Series B Convertible Preferred Stock and certain convertible notes. Additionally, in October 2007, warrants were issued to the underwriters in connection with the IPO. In 2009 warrants were issued to investors as part of our Shelf Registration Offering. The significant terms of the Series A, Series B, Note, Underwriter and Investor warrants were as follows:

Series A Warrants—The warrants issued with the sale of Series A Preferred Stock were issued on the basis of 0.20 of a warrant for every share of Series A Preferred Stock purchased. The exercise price of these warrants was $1.20 per share. We extended a limited-time offer to holders of the warrants to exercise them at a price of $0.80 per share. Any unexercised warrants expired on July 1, 2005, except for warrants issued in connection with later purchases of the Series A Preferred Stock for which the expiration date was extended to July 1, 2006.

Series B Warrants—The warrants issued with the sale of Series B Preferred Stock were issued on the basis of 0.175 of a warrant for every share of Series B Preferred Stock purchased. The exercise price of these warrants was $0.80 per share. Any unexercised warrants expired on June 30, 2006.

Note Warrants—Warrants were granted in connection with promissory notes issued to certain of our shareholders in 2002 and 2003. The warrants issued to these shareholders had an exercise price of $1.20 per share. Any unexercised

warrants expired on June 30, 2006.

Underwriter Warrants—In connection with the IPO, the Company issued warrants to the underwriters to purchase an aggregate of 350,000 shares of common stock at an exercise price of $4.00 per share. The warrants were exercisable on or after October 31, 2008 and expire on October 31, 2010. The warrants were valued at approximately $524,000 using the Black-Scholes-Merton option-pricing model based upon the following assumptions: (1) expected price volatility of 50.0%, (2) a risk-free interest rate of 3.94% and (3) a contractual life of 3 years. The Company accounted for the fair value of the Underwriter Warrants as an expense of the IPO resulting in a charge to stockholders' equity.

Advisory Services Warrants - In April 2008, the Company issued a two year warrant and a four year warrant to purchase an aggregate of 300,000 shares of common stock to PM Holdings Ltd. as part of our consideration for the revision of the agreement dated February 13, 2007 with PM Holdings. Under the terms of the original agreement, the Company agreed to pay PM Holdings $28,000 per month through February 2010 for financial and investor relations advisory services. The amendment to this agreement eliminated the monthly cash payment obligation and instead provided for a one-time, upfront cash payment of $264,000 and the issuance of warrants to purchase 300,000 shares of common stock at an exercise price of $4.00 per share. The warrants were valued at approximately $162,000 using the Black-Scholes-Merton option-pricing model based upon the following assumptions: (1) expected price volatility of 50.0%, (2) a risk-free interest rate of 3.94% and (3) a contractual life of 2 years. The Company accounts for the fair value of the Advisory Services Warrants as an expense amortized over the life of the warrants.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Investor Warrants—In August 2009, in connection with the Shelf Registration Offering, the Company issued warrants to the investors to purchase an aggregate of 1,225,000 shares of common stock at an exercise price of $2.75 per share. The warrants are exercisable on or after February 17, 2010 and expire on August 21, 2014.

At December 31, 2009, there were outstanding warrants to purchase 650,000 shares of common stock at a weighted-average exercise price of $4.00 per share. Additionally, there were outstanding warrants to purchase 1,225,000 shares of common stock from the Shelf Registration Offering at the exercise price of $2.75 per share. None of the warrants were exercisable at December 31, 2009.

The following table summarizes information about the Company's warrants outstanding at December 31, 2009, 2008 and 2007 and activity during the three years then ended.

(in thousands, except per share data)	Warrants	Weighted-Average Exercise Price
Outstanding at December 31, 2006	-	$ -
Warrants granted	350	$ 4.00
Outstanding at December 31, 2007	350	$ 4.00
Warrants granted	300	$ 4.00
Outstanding at December 31, 2008	650	$ 4.00
Warrants granted	1,225	$ 2.75
Outstanding at December 31, 2009	1,875	$ 3.18

NOTE 10. EQUITY-BASED COMPENSATION

Equity Compensation Plans

Prior to the 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. At the inception of the 2007 Plan, 2,000,000 shares were reserved for issuance under the Plan. Beginning in January 2009, the number of shares of common stock authorized for issuance under the 2007 Plan increases annually in an amount equal to the lesser of (a) 1,000,000 shares or (b) 4% of the number of shares of the Company's common stock outstanding on the last day of the preceding year or (c) such lesser number as determined by the board of directors. Accordingly, an additional 858,766 shares of common stock were authorized for issuance under the 2007 Plan in January 2009. As of December 31, 2009, there were 550,995 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.

NOVABAY PHARMACEUTICALS, INC.
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Stock Options Summary

The following table summarizes information about the Company's stock options outstanding at December 31, 2009, 2008 and 2007 and activity during the three years then ended.

(in thousands, except per share data)	Options	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life (years)	Aggregate Intrinsic Value
Outstanding at December 31, 2006	2,401	$ 0.83		
Options granted	814	$ 3.30		
Options exercised	(298)	$ 0.38		
Options forfeited/cancelled	(21)	$ 1.52		
Outstanding at December 31, 2007	2,896	$ 1.57		
Options granted	903	$ 2.39		
Options exercised	(122)	$ 1.18		
Options forfeited/cancelled	(306)	$ 2.66		
Outstanding at December 31, 2008	3,371	$ 1.70		
Options granted	1,196	$ 1.80		
Options exercised	(119)	$ 0.62		
Options forfeited/cancelled	(301)	$ 2.42		
Outstanding at December 31, 2009	4,147	$ 1.71	7.0	$2,456
Vested and expected to vest at December 31, 2009	3,973	$ 1.69	6.9	$2,427
Vested at December 31, 2009	2,360	$ 1.41	5.5	$2,084
Exercisable at December 31, 2009	2,532	$ 1.53	5.6	$2,099

The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying stock option awards and the closing market price of the Company's common stock as quoted on the NYSE Amex as of December 31, 2009. The Company received cash payments for the exercise of stock options in the amount of $114,000, $149,000 and $74,000 during the years ended December 31, 2007, 2008 and 2009, respectively. The aggregate intrinsic value of stock option awards exercised was $571,000, $108,000 and $148,000 for the years ended December 31, 2007, 2008 and 2009, respectively, as determined at the date of option exercise.

The options outstanding and vested by exercise price at December 31, 2009 were as follows (number of options in thousands):

	Options Outstanding			Options Vested	
Range of Exercise Prices	Number Outstanding	Weighted-Average Remaining Contractual Life (years)	Weighted-Average Exercise Price	Number Vested	Weighted-Average Exercise Price

$0.20	494	2.1	$ 0.20	494	$ 0.20
$0.30	318	4.0	$ 0.30	318	$ 0.30
$0.56	162	4.5	$ 0.56	154	$ 0.56
$1.20 - $1.56	503	8.3	$ 1.39	180	$ 1.24
$1.70 - $1.99	1,686	8.2	$ 1.82	742	$ 1.75
$2.00 - $2.41	407	8.1	$ 2.25	158	$ 2.26
$3.56 - $4.00	577	8.0	$ 3.69	314	$ 3.69
	4,147	7.0	$ 1.71	2,360	$ 1.41

Stock Option Awards to Employees and Directors

The Company grants options to purchase common stock to some of 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 certain stock option awards as of the date of the grant by applying the Black-Scholes-Merton option pricing valuation 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.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The weighted average assumptions used in determining the value of options granted and a summary of the methodology applied to develop each assumption are as follows:

	Year Ended December 31,		
Assumption	2007	2008	2009
Expected price volatility	68.9%	70.3%	87.1%
Expected term (in years)	6.0	6.1	6.1
Risk-free interest rate	4.1%	3.1%	2.4%
Dividend yield	0.0%	0.0%	0.0%
Weighted-average fair value of options granted during the period	$2.17	$1.56	$1.31

Expected Price Volatility—This is a measure of the amount by which the stock price has fluctuated or is expected to fluctuate. The computation of expected volatility was based on the historical volatility of comparable companies from a representative peer group selected based on industry and market capitalization data. An increase in the expected price volatility will increase the value of the option granted and the related compensation expense.

Expected Term—This is the period of time over which the options granted are expected to remain outstanding. Because there is insufficient historical information available to estimate the expected term of the stock-based awards, we adopted the simplified method for estimating the expected term pursuant to SAB No. 107. On this basis, we estimated the expected term of options granted by taking the average of the vesting term and the contractual term of the option. An increase in the expected life will increase the value of the option granted and the related compensation expense.

Risk-Free Interest Rate—This is the U.S. Treasury rate for the week of the grant having a term approximating the expected life of the option. An increase in the risk-free interest rate will increase the value of the option granted and the related compensation expense.

Dividend Yield—We have not made any dividend payments nor do we have plans to pay dividends in the foreseeable future. An increase in the dividend yield will decrease the value of the option granted and the related compensation expense.

Forfeitures are estimated at the time of grant and reduce compensation expense ratably over the vesting period. This estimate is adjusted periodically based on the extent to which actual forfeitures differ, or are expected to differ, from the previous estimate. For the years ended December 31, 2007 and 2009, we applied an estimated forfeiture rate of 5% to employee grants and 0% to director grants. Due to employee turnover in 2008, we applied an estimated forfeiture rate of 20% to employee grants and 0% to director grants.

For the years ended December 31, 2007, 2008 and 2009, we recognized stock-based compensation expense of $399,000 $721,000 and $702,000, respectively, for option awards to employees and directors. As of December 31, 2009, total unrecognized compensation cost related to unvested stock options granted or modified on or after January 1, 2006 was $2.0 million. This amount is expected to be recognized as stock-based compensation expense in our statements of operations over the remaining weighted average vesting period of 2.8 years.

Common Stock Awards to Directors

In connection with the close of the IPO in October 2007, in December 2009 the Company adopted a new plan to compensate the independent members of the Board of Directors for their services. Under the terms of the Director Compensation Plan, each independent member is entitled to a combination of cash and stock options, at their discretion, for their participation in the board and various committees. If the director elects to receive stock options these are issued to the director at the beginning of the year and vest over the term of the year. Cash payments are made quarterly at the beginning of each quarter.

In accordance with these provisions, the Company issued 51,000 and 130,000 shares of common stock to independent directors during the years ended December 31, 2008 and 2009, respectively. These shares were issued out of the 2007 Plan. The fair market value of the stock issued to directors was recorded as an operating expense in the period in which the meeting occurred, resulting in total compensation expense of $124,000 and $218,000 for common stock awards to directors during the years ended December 31, 2008 and 2009, respectively.

Summary of Stock-Based Compensation Expense

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

A summary of the stock-based compensation expense included in results of operations for the option and stock awards to employees and directors discussed above is as follows:

	Year ended December 31,		
(in thousands)	2007	2008	2009
Research and development	$206	$412	$548
General and administrative	222	432	372
Total stock-based compensation expense	$428	$844	$920

Stock-Based Awards to Non-Employees

During the years ended December 31, 2007, 2008 and 2009, the Company granted options to purchase an aggregate of 69,000, 16,000 and 273,000 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:

	Year Ended December 31,		
Assumption	2007	2008	2009
Expected price volatility	71.0%	70.0%	87.2%
Expected term (in years)	5.3	6.1	5.6
Risk-free interest rate	4.7%	3.1%	1.9%
Dividend yield	0.0%	0.0%	0.0%
Weighted-average fair value of options granted during the period	$1.70	$1.26	$1.41

For the years ended December 31, 2007 and 2009, the Company recognized stock-based compensation expense of $118,000 and $273,000, respectively, related to non-employee option grants. For the year ended December 31, 2008 the Company reversed previously recognized expense of $13,000 due to the required revaluation of unvested non-employee grants.

NOTE 11. COLLABORATION AND LICENSE AGREEMENTS

Alcon Manufacturing, Ltd.

In August 2006, we entered into a collaboration and license agreement with Alcon Manufacturing, Ltd. (“Alcon”) to license to Alcon the exclusive rights to develop, manufacture and commercialize products incorporating the Aganocide compounds for application in connection with the eye, ear and sinus and for use in contact lens solution. Under the terms of the agreement, Alcon agreed to pay an up-front, non-refundable, non-creditable technology access fee of $10.0 million upon the effective date of the agreement. This up-front fee was recorded as deferred revenue and is being amortized into revenue on a straight-line basis over the four-year funding term of the agreement, through August 2010. Additionally, we will receive semi-annual payments to support on-going research and development activities over the four year funding term of the agreement. The research and development support payments include amounts to fund a specified number of personnel engaged in collaboration activities and to reimburse for qualified equipment, materials and contract study costs. Our obligation to perform research and development activities under

the agreement expires at the end of the four year funding term. As product candidates are developed and proceed through clinical trials and approval, we will receive milestone payments. If the products are commercialized, we will also receive royalties on any sales of products containing the Aganocide compound. Alcon has the right to terminate the agreement in its entirety upon nine months' notice, or terminate portions of the agreement upon 135 days' notice, subject to certain provisions. Both parties have the right to terminate the agreement for breach upon 60 days' notice.

Revenue has been recognized as follows:

	Year Ended December 31,		
(in thousands)	2007	2008	2009
Amortization of Upfront Technology Access Fee	$2,500	$2,500	$2,500
On-going Research and Development	2,700	2,700	4,322
Materials, Equipment, and Contract Study Costs	611	1,386	1,349
Milestone Payment	-	-	1,000
	$5,811	$6,586	$9,171

At December 31, 2007, 2008 and 2009, we had deferred revenue balances of $7.4 million, $4.2 million and $1.7 million, respectively, related to the Alcon agreement which was comprised of $6.7 million, $4.2 million and $1.7 million, respectively, for the upfront technology access fee and $0.7 million, $0 and $0, respectively, for other prepaid reimbursements.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Galderma

On March 25, 2009, the Company announced that it entered into an 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) and orphan drug indications. The Company amended this agreement on December 17, 2009. This agreement is exclusive and worldwide in scope, with the exception of Asian markets where the Company has commercialization rights, and North America, where the Company has an option to exercise co-promotion rights. Galderma will be responsible for the development costs of the acne and other indications, except in Japan, in which Galderma has the option to request that we share such development costs, and for the ongoing development program for impetigo, upon the achievement of a specified milestone. Galderma will also reimburse NovaBay for the use of its personnel in support of the collaboration. NovaBay retains the right to co-market products resulting from the agreement in Japan. In addition, NovaBay has retained all rights in other Asian markets outside Japan, and has the right to co-promote the products developed under the agreement in the hospital and other healthcare institutions in North America. Upon the termination of the agreement under certain circumstances, Galderma will grant NovaBay certain technology licenses which would require NovaBay to make royalty payments to Galderma for such licenses with royalty rates in the low- to mid-single digits.

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. Upon the termination of the agreement under certain circumstances, Galderma will grant NovaBay certain technology licenses which would require NovaBay to make royalty payments to Galderma for such licenses with royalty rates in the low-to- mid single digits.

Revenue has been recognized under the Galderma agreement as follows:

	Year Ended December 31,		
(in thousands)	2007	2008	2009
Amortization of Upfront Technology Access Fee	$-	$-	$500
On-going Research and Development	-	-	1,200
Materials, Equipment, and Contract Study Costs	-	-	1,063
Milestone Payments	-	-	3,750
	$-	$-	$6,513

The Company had deferred revenue balances of $0 and $500,000 respectively, at December 31, 2008 and December 31, 2009, related to the Galderma agreement, which consisted of the remaining amount to be amortized for the upfront technology access fee. As of December 31, 2009, the Company has earned $3.75 million in milestone payments. This balance was included in accounts receivable as of December 31, 2009. As of December 31, 2009, the Company has not earned or received any royalty payments under the Galderma agreement.

KCI International VOF GP

In June 2007, we entered into a license agreement with an affiliate of Kinetic Concepts, Inc. ("KCI"), under which we granted KCI the exclusive rights to develop, manufacture and commercialize NVC-101, or NeutroPhase, as well as

other products containing hypochlorous acid as the principal active ingredient, worldwide for use in wound care in humans, other than products or uses intended for the eye, ear or nose. Under the terms of the agreement, KCI paid to us a non-refundable technology access fee of $200,000. The up-front technology access fee was recorded as deferred revenue and has been amortized into revenue on a straight-line basis over the 18-month performance obligation period, through December 2008. Under the agreement, we are also entitled to receive reimbursements for qualified consulting, materials and contract study costs. In addition, we are entitled to receive payments of up to $1.25 million if certain milestones are met. If products covered by the license are commercially launched, we will also receive royalty payments based on net revenues from sales by KCI of such products. KCI has the right to terminate the agreement without penalty upon 60 days' notice. We have the right to terminate the agreement if KCI has not commercially launched a product incorporating NVC-101, or any other product containing hypochlorous acid, within 18 months of the date of the agreement. Both parties have the right to terminate the agreement for breach upon 60 days' notice. On November 19, 2009, the agreement between KCI and NovaBay was mutually terminated.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Revenue has been recognized as follows:

	Year Ended December 31,		
(in thousands)	2007	2008	2009
Amortization of Upfront Technology Access Fee	$72	$128	$-
On-going Research and Development	30	8	-
Materials, Equipment, and Contract Study Costs	-	-	-
	$102	$136	$-

As of December 31, 2009, we had no deferred revenue related to the KCI agreement and we had not earned or received any milestone or royalty payments under the KCI agreement.

NOTE 12. EMPLOYEE BENEFIT PLAN

We have a 401(k) plan covering all eligible employees. We are not required to contribute to the plan and have made no contributions through December 31, 2009.

NOTE 13. INCOME TAXES

Net income (loss) before provision for income taxes consisted of the following (in thousands):

	Year Ending December 31		
	2007	2008	2009
United States	(5,388)	(8,112)	2,704
International	-	-	-
	(5,388)	(8,112)	2,704

The federal and state income tax provision (benefit) is summarized as follows (in thousands):

	Year Ending December 31		
(in thousands)	2007	2008	2009
Current			
Federal	$-	$-	$-
State	12	2	7
Other	-	-	-
Total Current Tax Expense	12	2	7
Deferred			
Federal	-	-	-
State	-	-	-
Other	-	-	-
Total Deferred Tax Expense	-	-	-
Total Tax Expense	$12	$2	$7

Deferred income taxes reflect the net tax effects of (a) temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes, and (b) operating losses and tax credit carryforwards.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The tax effects of significant items comprising the Company's deferred taxes as of December 31 are as follows:

	Year Ending December 31	
(in thousands)	2008	2009
Deferred Tax Assets:		
Accruals	$409	$296
Deferred Revenue	1,660	664
Net Operating Losses	7,946	7,780
Stock Options	176	406
Other Deferred Tax Assets	45	54
Total Deferred Tax Assets	10,236	9,200
Deferred Tax Liabilities:		
Property, Plant & Equipment	(228)	(322)
Total Deferred Tax Liabilities	(228)	(322)
Valuation Allowance	$(10,008)	$(8,878)
Net Deferred Taxes	$-	$-

ASC 740 requires that the tax benefit of net operating losses, temporary differences and credit carryforwards be recorded as an asset to the extent that management assesses that realization is "more likely than not." Realization of the future tax benefits is dependent on the Company's ability to generate sufficient taxable income within the carryforward period. Because of the Company's recent history of operating losses, management believes that recognition of the deferred tax assets arising from the above-mentioned future tax benefits is currently not likely to be realized and, accordingly, has provided a valuation allowance.

The valuation allowance increased by the following amounts (in thousands):

2007	2008	2009
$1,997	$2,978	$(1,130)

We track the portion of our federal and state net operating loss carryforwards attributable to stock option benefits in a separate memo account. Therefore, these amounts are not included in gross or net deferred tax assets.

The benefit of these net operating loss carryforwards will only be recorded to equity when they reduce cash taxes payable.

Net operating losses and tax credit carryforwards as of December 31, 2009 are as follows (in thousands):

	Amount	Expiration Years
Net operating losses, federal	$20,025	2024 - 2029
Net operating losses, state	$20,012	2016 - 2029
Tax credits, state	$15	N/A

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The effective tax rate of the Company's provision (benefit) for income taxes differs from the federal statutory rate as follows:

	Year Ending December 31		
(in thousands)	2007	2008	2009
Statutory Rate	$(1,832)	$(2,758)	$950
State Tax	(274)	(435)	152
ISO Related Expense for GAAP	81	207	196
Change in Valuation Allowance	1,997	2,978	(1,130)
Other	40	10	(161)
Total	$12	$2	$7

Uncertain Income Tax Positions

We adopted the provisions of ASC 740-10 on January 1, 2007. There was no impact on our consolidated financial position, results of operations and cash flows as a result of adoption. We have no unrecognized tax benefit as of December 31, 2009, including no accrued amounts for interest and penalties.

Our policy will be to recognize interest and penalties related to income taxes as a component of income tax expense. We are subject to income tax examinations for U.S. incomes taxes and state income taxes from 2004 forward. We do not anticipate that total unrecognized tax benefits will significantly change prior to December 31, 2010.

NOTE 14. SUBSEQUENT EVENTS

We evaluated subsequent events through March 26, 2010 when these financial statements were issued. We are not aware of any significant events that occurred subsequent to the balance sheet date but prior to the filing of this Annual Report on Form 10-K that would have a material impact on our Consolidated Financial Statements

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

Not applicable.

ITEM 9A(T). CONTROLS AND PROCEDURES

Evaluation of Disclosure 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 our disclosure controls and procedures were effective 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. Our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level.

Management’s Report on Internal Control over Financial Reporting.

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f) and 15d-15(f). Under the supervision and with the participation of our management, including our principal executive officer and our principal financial officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2009. In making this assessment, our management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control — Integrated Framework. Our management has concluded that, as of December 31, 2009, our internal control over financial reporting was effective based on these criteria.

This annual report does not include an attestation report of the company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the company's registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the company to provide only management's report in this annual report.

This report shall not be deemed to be filed for purposes of Section 18 of the Exchange Act or otherwise subject to the liabilities of that section, unless the registrant specifically states that the report is to be considered "filed" under the Exchange Act or incorporates it by reference into a filing under the Securities Act or the Exchange Act.

Changes in Internal Control Over Financial Reporting

During the fourth quarter of 2009, there were no changes in our internal control over financial reporting which has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

On March 25, 2010 the board of directors approved a new employee cash bonus plan. The plan provides for a target bonus award opportunity for each employee, set as a percent of base salary. Actual awards may be modified upward or downward based on the achievement of individual and corporate performance objectives established at the beginning of the year or due to other factors solely at the discretion of the board and management. The bonus will also be weighted between individual and corporate performance factors which will vary based on reporting levels and responsibility. The employee cash bonus plan is filed as Exhibit 10.7 to this Annual Report on Form 10-K.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by this Item with respect to Executive Officers may be found under the caption, "Executive Compensation and Other Information" appearing in the definitive Proxy Statement to be delivered to NovaBay's stockholders in connection with the solicitation of proxies for NovaBay's 2010 Annual Meeting of Stockholders (the "Proxy Statement"). The information required by this Item with respect to Directors, including information with respect to our audit committee, audit committee financial experts, risk management and procedures for Board nominations, is incorporated herein by reference from the information under the caption, "Proposal One: Election of Directors" and "Corporate Governance" appearing in the Proxy Statement.

Section 16(a) Beneficial Ownership Reporting Compliance

The information required by this Item with respect to compliance with Section 16(a) of the Exchange Act is incorporated herein by reference from the section captioned "Section 16(a) Beneficial Ownership Reporting Compliance" contained in the Proxy Statement.

Code of Ethics and Business Conduct

The information required by this Item with respect to our code of ethics and business conduct is incorporated herein by reference from the section captioned "Corporate Governance" contained in the Proxy Statement.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this Item is set forth in the Proxy Statement under the caption, "Executive Compensation and Other Information." Such information is incorporated herein by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by this Item with respect to security ownership of certain beneficial owners and management is set forth in the Proxy Statement under the caption, "Security Ownership of Certain Beneficial Owners and Management" and "Equity Compensation Plan Information." Such information is incorporated herein by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by this Item is set forth in the Proxy Statement under the headings "Proposal 1: Election of Directors" and "Certain Relationships and Related Transactions." Such information is incorporated herein by reference.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The information required by this Item is set forth in the Proxy Statement under the heading "Fees Paid to Independent Registered Public Accounting Firm." Such information is incorporated herein by reference.

Consistent with Section 10A(i)(2) of the Securities Exchange Act of 1934, as added by Section 202 of the Sarbanes-Oxley Act of 2002, we are responsible for listing the non-audit services approved by our Audit Committee to be performed by Davidson & Company LLP, our external auditor. Non-audit services are defined as services other than those provided in connection with an audit or a review of our financial statements. Our Audit Committee has

approved our recurring engagements of non-audit services of Moss Adams, LLP for the preparation of tax returns, and tax advice in preparing for and in connection with such filings.

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

(a) Documents filed as part of this report:

(1) Financial Statements. The following financial statements of NovaBay Pharmaceuticals, Inc. are included in Item 8 of this Annual Report on Form 10-K commencing on the pages referenced below:

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

(2) Financial Statement Schedules.

All schedules have been omitted because they are not required or the required information is included in our consolidated financial statements and notes thereto.

(3) Exhibits.

See the Exhibit Index which follows the signature page of this Annual Report on Form 10-K, which is incorporated herein by reference.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report on Form 10-K to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: March 26, 2010 NOVABAY PHARMACEUTICALS, INC.

By: /S/ RAMIN NAJAFI
Ramin ("Ron") Najafi
Chief Executive Officer and President

POWER OF ATTORNEY

We, the undersigned officers and directors of NovaBay Pharmaceuticals, Inc., do hereby constitute and appoint Ramin ("Ron") Najafi and Thomas J. Paulson, and each of them, our true and lawful attorneys-in-fact and agents, each with full power of substitution and resubstitution, for him and in his name, place and stead, in any and all capacities, to sign any and all amendments to this report, and to file the same, with exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, and each of them, full power and authority to do and perform each and every act and thing requisite or necessary to be done in and about the premises, as fully to all intents and purposes as he might or could do in person, hereby, ratifying and confirming all that each of said attorneys-in-fact and agents, or his substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report on Form 10-K has been signed below by the following persons on behalf of the registrant in the capacities and on the dates indicated:

Signature	Title	Date
/S/ RAMIN NAJAFI Ramin ("Ron") Najafi	Chairman of the Board, Chief Executive Officer and President (principal executive officer)	March 25, 2010
/S/ THOMAS PAULSON Thomas J. Paulson	Chief Financial Officer and Treasurer (principal financial and accounting officer)	March 25, 2010
/S/ CHARLES J. CASHION Charles J. Cashion	Director	March 23, 2010
/S/ ANTHONY DAILLEY Anthony Dailley, DDS	Director	March 24, 2010
/S/ PAUL FREIMAN Paul E. Freiman	Director	March 24, 2010
/S/ ALEX MCPHERSON Alex McPherson, MD, Ph.D.	Director	March 23, 2010
/S/ ROBERT R. TUFTS Robert R. Tufts	Director	March 24, 2010

/S/ TONY WICKS Tony Wicks	Director	March 23, 2010
/S/ HARRY F. HIXSON, JR., PhD Harry F. Hixson	Director	March 26, 2010

EXHIBIT INDEX

Exhibit No.	Description
3.1	Amended and Restated Articles of Incorporation of the Company (Incorporated by reference to the exhibit of the same number from the Company's quarterly report on Form 10-Q for the quarter ended September 30, 2007 as filed with the SEC on November 15, 2007 (SEC File No. 001-33678).)
3.2	Amended and Restated Bylaws of the Company (Incorporated by reference to the exhibit of the same number from the Company's quarterly report on Form 8-K as filed with the SEC on January 26, 2010 (SEC File No. 001-33678).)
4.1*	Specimen common stock certificate
4.2	Form of Form of Common Stock Purchase Warrant issued in August 2009. (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).)
10.1*+	2002 Stock Option Plan, and forms of agreements thereto
10.2*+	2005 Stock Option Plan, and forms of agreements thereto
10.3*+	2007 Omnibus Incentive Plan, and forms of agreements thereto ((the Plan is incorporated by reference to Exhibit 10.1 from the Company's quarterly report on Form 10-Q for the quarter ended June 30, 2008 as filed with the SEC on August 14, 2008 (SEC File No. 001-33678), and the forms of agreements thereto are incorporated by reference to the exhibit referencing the Plan from the Company's amendment to registration statement of Form S-1 (File No. 333-140714) filed with the Securities and Exchange Commission on May 29, 2007, as amended.)
10.4*+	Employment Agreement dated January 1, 2007 by and between the Company and Ramin ("Ron") Najafi
10.5*+	Employment Agreement dated January 1, 2007 by and between the Company and John ("Jack") O'Reilly
10.6*+	Employment Agreement dated January 1, 2007 by and between the Company and Behzad Khosrovi
10.7+	NovaBay Pharmaceuticals, Inc. Employee Incentive Cash Compensation Plan.
10.8*+	Employment Agreement dated January 9, 2008 by and between the Company and Thomas J. Paulson (Incorporated by reference to Exhibit 10.18 from the Company's annual report on Form 10-K for the year end December 31, 2007 as filed with the SEC on March 14, 2008 (SEC File No. 001-33678).)
10.9+	Retirement and Consulting Agreement dated January 1, 2009 by and Between the Company and John ("Jack") O'Reilly (Incorporated by reference to Exhibit 10.9 from the Company's

annual report on Form 10-K for the year end December 31, 2008, as filed with the SEC on March 31, 2009 (SEC File No. 001-33678).)

10.10* Office Lease dated June 3, 2004 by and between the Company and Emery Station Associates II, LLC, as amended

10.11 Fifth Amendment dated November 20, 2007 to Office Lease dated June 3, 2004 by and between the Company and Emery Station Associates II, LLC, as amended (Incorporated by reference to Exhibit 10.20 from the Company's annual report on Form 10-K for the year ended December 31, 2007 as filed with the SEC on March 14, 2008 (SEC File No. 001-33678).)

10.12 Sixth Amendment to Lease between Emery Station Office II, LLC and Novacal Pharmaceuticals, Inc., effective September 1, 2008. (Incorporated by reference to Exhibit 10.1 from the Company's quarterly report on Form 10-Q/A for the quarter ended September 30, 2008 as filed with the SEC on November 14, 2008 (SEC File No. 001-33678).)

10.13† Collaboration and License Agreement, by and between the Company and Galderma S.A., dated as of March 20, 2009 (Incorporated by reference to Exhibit 10.2 from the Company's quarterly report on Form 10-Q/A for the quarter ended March 31, 2009, as filed with the SEC on August 4, 2009 (SEC File No. 001-33678).)

10.14+ Director Compensation Plan

10.15*† Collaboration and License Agreement dated August 29, 2006 by and between the Company and Alcon Manufacturing, Ltd.

10.16*	Master Security Agreement dated April 23, 2007 by and between the Company and General Electric Capital Corporation
10.17*	Form of Common Stock Purchase Warrant by and between the Company and the underwriters
10.18††	Amendment No. 1 to the Collaboration and License Agreement, dated as of December 1, 2009, between the Company and Galderma S.A.
10.19+	Named Executive Officer Cash Compensation Arrangements
10.20+	Employment Agreement, dated July 28, 2009, between the Company and Roy Wu.
10.21	Placement Agent Agreement, dated August 21, 2009, by and between the Company and Maxim Group LLC (Incorporated by reference to Exhibit 1.1 from the Company's quarterly report on Form 8-K as filed with the SEC on August 21, 2009 (SEC File No. 001-33678)).
10.22+	Employment Agreement, dated October 15, 2009, between the Company and Mark Anderson.
23.1	Consent of Davidson & Company LLP
24.1	Power of Attorney (included on the signature pages hereto)
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

* Incorporated by reference to the exhibit of the same description from the Company's registration statement of Form S-1 (File No. 333-140714) initially filed with the Securities and Exchange Commission on February 14, 2007, as amended.

+ Indicates a management contract or compensatory plan or arrangement

† NovaBay Pharmaceuticals, Inc. has been granted confidential treatment with respect to certain portions of this exhibit (indicated by asterisks), which have been separately filed with the Securities and Exchange Commission.

†† NovaBay Pharmaceuticals, Inc. has requested confidential treatment with respect to certain portions of this exhibit (indicated by asterisks), which have been separately filed with the Securities and Exchange Commission.

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