COPART INC
Form DEF 14A
October 19, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

SCHEDULE 14A INFORMATION

PROXY STATEMENT PURSUANT TO SECTION 14(a) OF THE

SECURITIES EXCHANGE ACT OF 1934

Filed by the Registrant x Filed by a Party other than the Registrant ¨

Check the appropriate box:

¨

Preliminary Proxy Statement

¨

Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))

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Definitive Proxy Statement

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Definitive Additional Materials

¨

Soliciting Material Pursuant to §240.14a-11(c) or §240.14a-2

COPART, INC.

(Name of Registrant as Specified In Its Charter)

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

Payment of Filing Fee (Check the appropriate box):

x

No fee required.

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(1)

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Proposed maximum aggregate value of transaction:

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

(1)

Amount Previously Paid:

(2)

Form, Schedule or Registration Statement No.:

(3)

Filing Party:

(4)

Date Filed:

14185 Dallas Parkway, Suite 300
Dallas, Texas 75254
(972) 391-5000

October 19, 2012

Dear Stockholder:

You are cordially invited to attend the 2012 Annual Meeting of Stockholders of Copart, Inc. to be held on Wednesday, December 5, 2012, at 9:00 a.m., Central time, at Copart s corporate headquarters located at 14185 Dallas Parkway, Suite 300, Dallas, Texas 75254. The formal meeting notice and proxy statement are attached.

At this year s annual meeting, our stockholders will be asked:

To elect the eight nominees for director named in the proxy statement to hold office until our 2013 annual meeting of stockholders or until their respective successors have been duly elected and qualified;

To vote to approve, on an advisory basis, the compensation of our named executive officers for the fiscal year ended July 31, 2012;

To ratify the appointment by the audit committee of our board of directors of Ernst & Young LLP as our independent registered public accounting firm for the fiscal year ending July 31, 2013; and

To transact such other business as may properly come before the annual meeting or any adjournment or postponement of the annual meeting.

Your vote is important. Whether or not you plan to attend the annual meeting, it is important that your shares be represented, and we hope you will vote as soon as possible. You may vote over the Internet, or, if you requested to receive printed proxy materials, by telephone or by mailing a completed, signed and dated proxy or voting instruction card. Please review the instructions on each of your voting options as described in the proxy statement, as well as in the Notice of Internet Availability of Proxy Materials that you received in the mail. If you hold shares of our common stock through a broker, bank, or other nominee holder, please follow the voting instructions provided by such broker, bank, or other nominee holder. Returning the proxy card or voting electronically or telephonically does not deprive you of your right to attend the meeting and to vote your shares in person for the matters acted upon at the annual meeting.

Thank you for your ongoing support of Copart. We look forward to seeing you at our 2012 Annual Meeting.

Sincerely,

WILLIS J. JOHNSON
Chairman

The Notice of Internet Availability of Proxy Materials is first being mailed to our stockholders on or about October 19, 2012. The proxy materials are first being posted on https://materials.proxyvote.com/217204 on or about October 19, 2012.

COPART, INC.
14185 Dallas Parkway, Suite 300
Dallas, Texas 75254
(972) 391-5000

NOTICE OF 2012 ANNUAL MEETING OF STOCKHOLDERS

Time and Date	9:00 a.m., Central time, on Wednesday, December 5, 2012
Place	Copart s corporate headquarters located at 14185 Dallas Parkway, Suite 300, Dallas, Texas 75254
Items of Business	To elect the eight nominees for director named in this proxy statement to hold office until our 2013 annual meeting of stockholders or until their respective successors are duly elected and qualified. To vote to approve, on an advisory basis, the compensation of our named executive officers for the fiscal year ended July 31, 2012. To ratify the appointment by the audit committee of our board of directors of Ernst & Young LLP as our independent registered public accounting firm for the fiscal year ending July 31, 2013. To transact any other business that may properly come before the annual meeting.
Record Date	You are entitled to vote only if you were a Copart stockholder of record as of the close of business on the record date, October 9, 2012.
Meeting Admission	**You are entitled to attend the annual meeting only if you were a Copart stockholder as of the close of business on the record date or otherwise hold a valid proxy for the annual meeting**. If you are not a stockholder of record but hold shares through a broker, bank, trustee, or nominee (*i.e*., in street name), you should provide proof of beneficial ownership as of the record date, such as your most recent account statement reflecting ownership on the record date, a copy of the voting instruction card provided by your broker, bank, trustee, or nominee, or similar evidence of ownership. A complete list of stockholders entitled to vote at the meeting will be available and open to examination by any stockholder for any purpose germane to the meeting for a period of at least ten days prior to the meeting during normal business hours at our corporate headquarters.
Annual Report	You may access our 2012 annual report by visiting http://materials.proxyvote.com/217204. Our 2012 annual report is not a part of the proxy solicitation materials.
Date of Mailing	The Notice of Internet Availability of Proxy Materials is first being mailed to our stockholders, and the proxy materials are first being posted on the Internet at http://materials.proxyvote.com/217204, on or about October 19, 2012.
Voting	Your vote is very important. Whether or not you plan to attend the annual meeting, we encourage you to read the proxy statement and submit your proxy or voting instructions as soon as possible. For specific instructions on how to vote your shares, please refer to the instructions in the section entitled Questions and Answers About the Proxy Materials and Annual Meeting beginning on page 1 of the proxy statement.

PROXY STATEMENT
FOR 2012 ANNUAL MEETING OF STOCKHOLDERS

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COPART, INC.
14185 Dallas Parkway, Suite 300
Dallas, Texas 75254
(972) 391-5000

PROXY STATEMENT
For the Annual Meeting of Stockholders
To Be Held December 5, 2012

QUESTIONS AND ANSWERS ABOUT THE PROXY MATERIALS AND ANNUAL MEETING

What is a proxy?

A proxy is your legal designation of another person to vote the stock you own. The person you designate is your proxy, and you give the proxy authority to vote your shares by voting over the Internet, or if you requested to receive printed proxy materials, by voting over the telephone or by submitting your proxy card in the prepaid return envelope provided to you. We have designated our Chief Executive Officer, A. Jayson Adair, and our Senior Vice President, General Counsel and Secretary, Paul A. Styer, to serve as proxies for the annual meeting.

Why am I receiving these materials?

We are providing these proxy materials in connection with the solicitation by the Board of Directors of Copart, Inc., a Delaware corporation of proxies to be voted at our 2012 Annual Meeting of Stockholders (and at any adjournment or postponement of such meeting). The annual meeting will take place on Wednesday, December 5, 2012 at 9:00 a.m., Central time, at our corporate headquarters located at 14185 Dallas Parkway, Suite 300, Dallas, Texas 75254. Directions to the annual meeting are included on page 47 of this proxy statement. As a stockholder, you are invited to attend the annual meeting and are requested to vote on the items of business described in this proxy statement.

Why did I receive a one-page notice in the mail regarding the Internet availability of proxy materials instead of a full set of proxy materials?

This year, we are pleased to be distributing our proxy materials to our stockholders via the Internet under the notice and access rules of the Securities and Exchange Commission, or the SEC. This approach conserves natural resources and reduces our costs of printing and distributing the proxy materials, while providing a convenient way to access the materials and vote. On October 19, 2012, we mailed a Notice of Internet Availability of Proxy Materials, or Notice of Internet Availability, to our stockholders, containing instructions on how to access the proxy materials on the Internet and submit your vote via the Internet. If you would like to receive a printed copy of the proxy materials, please follow the instructions for requesting such materials included in the Notice of Internet Availability. A printed copy of the proxy materials will be provided to you free of charge. Notwithstanding the foregoing, we encourage stockholders to take advantage of the availability of the proxy materials on the Internet to help reduce the environmental impact of our annual meetings.

In addition, you may request to receive your materials for all future meetings either by email or in paper form by mail. As noted above, choosing to receive future proxy materials by email notice will save us the cost of printing and mailing documents to you and will reduce the impact of our annual meetings on the environment. It will also give you faster access to view the proxy materials in an easily searchable format.

We mailed the Notice of Internet Availability on or about October 19, 2012 to all stockholders entitled to vote at the annual meeting. On the date of mailing of the Notice of Internet Availability, all stockholders and beneficial owners will have the ability to access all of our proxy materials on the website referred to in the Notice of Internet Availability. The proxy materials will also be available to the public at the following website: https://materials.proxyvote.com/217204. These proxy materials will be available free of charge.

What information is contained in this proxy statement?

The information in this proxy statement relates to the proposals to be voted on at the annual meeting, the voting process, the compensation of our directors and most highly paid executive officers, our corporate governance policies, information on our board of directors, and certain other required information. We use several abbreviations in this proxy statement. The term proxy materials means this proxy statement as well as the proxy card and our 2012 annual report to stockholders. References to fiscal year refer to our fiscal year beginning on August 1 of the prior year and ending on July 31 of the year stated.

What items of business will be voted on at the annual meeting?

The items of business scheduled to be voted on at the annual meeting are as follows:

To elect the eight nominees for director named in this proxy statement to hold office until our 2013 annual meeting of stockholders or until their respective successors are duly elected and qualified;

To vote to approve, on an advisory basis, the compensation of our named executive officers for the fiscal year ended July 31, 2012, as set forth in this proxy statement; and

To ratify the appointment by the audit committee of our board of directors of Ernst & Young LLP as our independent registered public accounting firm for the fiscal year ending July 31, 2013.

We will also transact any other business that may properly come before the annual meeting.

How does our board of directors recommend that I vote?

Our board of directors recommends that you vote your shares:

FOR each of the eight nominees for director named in this proxy statement.

FOR the approval, on an advisory basis, of the compensation of our named executive officers for the fiscal year ended July 31, 2012.

FOR the ratification of the appointment of Ernst & Young LLP as our independent registered public accounting firm for the 2013 fiscal year.

Who is entitled to vote at the Annual Meeting?

Each share of our common stock issued and outstanding as of the close of business on October 9, 2012, the record date for our annual meeting, is entitled to vote on all items being considered at the annual meeting. You may vote all shares owned by you as of the record date, including (i) shares held directly in your name as the stockholder of record and (ii) shares held for you as the beneficial owner in street name through a broker, bank, or other nominee. On the record date, we had 124,116,625 shares of common stock issued and outstanding.

How many votes am I entitled to per share?

For all matters described in this proxy statement for which your vote is being solicited, each holder of shares of common stock is entitled to one vote for each share of common stock held by such holder as of the record date.

Am I entitled to cumulate my votes at the annual meeting?

Under our certificate of incorporation in connection with the election of directors, each stockholder then entitled to vote in such election shall be entitled to as many votes as shall equal the number of votes which (except with respect to these cumulative voting rights) such holder would be entitled to cast for the election of directors with respect to such stockholder s shares of stock multiplied by the number of directors to be elected in the election in which such stockholder s shares are entitled to vote, and such stockholder may cast all of such votes for a single director or may distribute them among the number to be voted for, or for any two or more of them as such stockholder may see fit.

What is the difference between holding shares as a stockholder of record and as a beneficial owner?

Stockholder of Record

If your shares are registered directly in your name with our transfer agent, Computershare Trust Company, N.A., you are considered, with respect to those shares, the *stockholder of record*, and the Notice of Internet Availability has been sent directly to you. As the *stockholder of record*, you have the right to grant your voting proxy directly to our designated proxies or to vote in person at the annual meeting.

Beneficial Owner

Many of our stockholders hold their shares through a broker, trustee or other nominee, rather than directly in their own name. If your shares are held in a brokerage account or by a bank or another nominee, you are considered the *beneficial owner* of shares held in street name. The Notice of Internet Availability has been forwarded to you by your broker, trustee or nominee who is considered, with respect to those shares, the stockholder of record.

As a *beneficial owner*, you have the right to direct your broker, trustee or other nominee on how to vote your shares. For directions on how to vote shares beneficially held in street name, please refer to the voting instruction card provided by your broker, trustee or nominee. You are also invited to attend the annual meeting. However, because a *beneficial owner* is not the stockholder of record, you may not vote these shares in person at the annual meeting unless you obtain a legal proxy from the broker, trustee or nominee that holds your shares, giving you the right to vote the shares at the annual meeting.

How can I contact Copart s transfer agent?

You may contact our transfer agent, Computershare Trust Company, N.A., by telephone at (877) 282-1168, by facsimile at (781) 575-3605 or by writing Computershare Trust Company, N.A., P.O. Box 43078, Providence, Rhode Island, 02940-3078. You may also access instructions with respect to certain stockholder matters (*e.g.*, lost share certificates, change of address) via the Internet at www.computershare.com/investor.

How can I attend the annual meeting?

You are invited to attend the annual meeting if you were a stockholder of record as of the record date, October 9, 2012, you hold a valid proxy for the annual meeting, or you are a beneficial owner as of the record date, October 9, 2012. If you are a stockholder of record, meaning you hold shares directly in your name with Computershare Trust Company, N.A., please bring government-issued photo identification for entrance to the annual meeting. If you are not a stockholder of record but hold shares as a beneficial owner in street name, you should provide proof of beneficial ownership as of the record date, such as your most recent account statement reflecting stock ownership on the record date, October 9, 2012, together with a copy of the voting instruction card provided by your broker, bank, or nominee, or other similar evidence of ownership.

If you do not comply with the procedures outlined above, you may not be admitted to the annual meeting.

Please let us know if you plan to attend the meeting by marking the appropriate box on the proxy card or, if you vote by telephone, by indicating your plans when prompted, in either case, if you requested to receive printed materials or, if you vote by Internet, by indicating your plans when prompted.

Will the annual meeting be webcast?

We do not expect to webcast the annual meeting.

How can I vote my shares in person at the annual meeting?

Stockholders of record Shares held in your name as the stockholder of record may be voted by you in person at the annual meeting.

Beneficial owners Shares held beneficially in street name may be voted by you in person at the annual meeting only if you obtain a legal proxy from the broker, trustee, or other nominee that holds your shares giving you the right to vote the shares.

Even if you plan to attend the annual meeting, we recommend that you also submit your proxy or voting instructions as described below so that your vote will be counted if you later decide not to attend the annual meeting.

How can I vote my shares without attending the annual meeting?

By mail

If you requested to receive printed proxy materials, you can vote by mail. Please complete, sign and date the proxy or voting instruction card and return it in the prepaid envelope. If you are a stockholder of record and you return your signed proxy card but do not indicate your voting preferences, the persons named in the proxy card will vote the shares represented by your proxy card as recommended by our board of directors.

By telephone

If you requested to receive printed proxy materials, you may also vote by telephone. You can vote by calling the toll-free telephone number on your proxy card. Please have your proxy card handy when you call. Easy-to-follow voice prompts will allow you to vote your shares and confirm that your instructions have been properly recorded.

By Internet

The website for Internet voting is provided in the Notice of Internet Availability. You can vote by proxy over the Internet by following the instructions provided in the Notice of Internet Availability.

Telephone and Internet voting facilities for stockholders of record will be available 24 hours a day until 1:00 a.m., Central time, on December 5, 2012.

If you are a beneficial owner of shares, your broker, trustee or nominee you may also vote by proxy by following the voting instructions provided to you by your broker, trustee or nominee. The availability of telephone and Internet voting for beneficial owners will depend on the voting processes of your broker, trustee or nominee. Therefore, we recommend that you follow the voting instructions in the materials you receive.

If you vote by telephone or the Internet, you do not have to return your proxy or voting instruction card.

Can I change my vote or revoke my proxy?

Yes, you have the right to revoke your proxy at any time prior to the time your shares are voted. If you are the stockholder of record, you may revoke your vote by (i) granting a new proxy bearing a later date (which automatically revokes the earlier proxy) using any of the methods described above under the subheading How can I vote my shares without attending the annual meeting? (and until the applicable deadline for each method), (ii) providing a written notice of revocation to our corporate secretary at Copart, Inc., 14185 Dallas Parkway, Suite 300, Dallas, Texas 75254, Attn: Paul A. Styer, prior to your shares being voted, or (iii) attending the annual meeting and voting in person. Attendance at the meeting will not cause your previously granted proxy to be revoked unless you specifically so request.

For shares you hold beneficially in street name, you may change your vote by submitting new voting instructions to your broker, trustee, or nominee following the instructions they provided or, if you have obtained a legal proxy from your broker, trustee, or nominee giving you the right to vote your shares, by attending the annual meeting and voting in person.

Is there a list of stockholders entitled to vote at the annual meeting?

The names of stockholders of record entitled to vote at the annual meeting will be available at the annual meeting and for ten days prior to the meeting for any purpose germane to the meeting, between the hours of 9:00 a.m. and 4:30 p.m., at our corporate headquarters located at 14185 Dallas Parkway, Suite 300, Dallas, Texas 75254, by contacting our corporate secretary.

Is my vote confidential?

Proxy instructions, ballots, and voting tabulations that identify individual stockholders are handled in a manner that protects your voting privacy. Your vote will not be disclosed either within Copart or to third parties, except as necessary to meet applicable legal requirements, to allow for the tabulation of votes and certification of the vote, or to facilitate a successful proxy solicitation.

How many shares must be present or represented to conduct business at the annual meeting?

The quorum requirement for holding the annual meeting and transacting business is that the holders of a majority of the voting power of all of the shares of the stock entitled to vote at the meeting, present in person or by proxy, shall constitute a quorum. If there is no quorum, the chairman of the annual meeting may adjourn the meeting to another place, if any, date, or time. Abstentions and broker non-votes are counted as present and entitled to vote for purposes of determining a quorum.

What is a broker non-vote?

If you are a beneficial owner whose shares are held of record by a broker, trustee or nominee you must instruct the broker, trustee or nominee how to vote your shares. If you do not provide voting instructions, your shares will not be voted on any proposal on which the broker does not have discretionary authority to vote. This is called a broker non-vote. In these cases, the broker can register your shares as being present at the annual meeting for purposes of determining the presence of a quorum but will not be able to vote on those matters for which specific authorization is required. If you are a beneficial owner whose shares are held of record by a broker, trustee or nominee, your broker, trustee or nominee has discretionary voting authority to vote your shares on the ratification of the appointment of Ernst & Young LLP as our independent registered public accounting firm (Proposal 3), even if the broker has not received voting instructions from you. However, your broker does not have discretionary authority to vote on the election of directors (Proposal 1) or the advisory vote on the approval of executive compensation (Proposal 2) without instructions from you, in which case a broker non-vote will occur and your shares will not be voted on these matters. Accordingly, if you are a beneficial owner, it is particularly important that you provide your instructions for voting your shares on the election of directors (Proposal 1) and the advisory vote on the approval of executive compensation (Proposal 2) to your broker, trustee, or other nominee.

What is the voting requirement to approve each of the proposals?

Proposal	Vote Required	Discretionary Voting Allowed?
Election of directors	Plurality of the votes cast	No
Advisory Vote on Executive Compensation	Majority of the votes cast	No
Ratification of Appointment of Ernst & Young LLP	Majority of the votes cast	Yes

Election of Directors

The nominees receiving the highest number of affirmative FOR votes of the shares entitled to be voted at the annual meeting will be elected as directors. You may vote FOR or WITHHOLD for each director nominee. A properly executed proxy marked WITHHOLD with respect to the election of a director will not be voted with respect to such director although it will be counted for purposes of determining whether there is a quorum. Abstentions and broker non-votes will not affect the outcome of the election of directors.

Advisory Vote on Approval of Executive Compensation

Under our Bylaws, the votes cast FOR must exceed the votes cast AGAINST to approve, on an advisory basis, the compensation of our named executive officers for the fiscal year ended July 31, 2012. Abstentions and broker non-votes are not counted as votes FOR or AGAINST this proposal.

Ratification of Appointment of Ernst & Young LLP

Under our Bylaws, the votes cast FOR must exceed the votes cast AGAINST to approve the ratification of the appointment of Ernst & Young LLP as our independent registered public accounting firm. Abstentions are not counted as votes FOR or AGAINST this proposal.

What happens if additional matters are presented at the annual meeting?

Other than the items of business described in this proxy statement, we are not aware of any other business to be acted upon at the annual meeting. If you grant a proxy, the persons named as proxy holders, A. Jayson Adair and Paul A. Styer, or either of them, will have the discretion to vote your shares on any additional matters properly presented for a vote at the meeting. If for any reason any of the nominees is not available as a candidate for director, the persons named as proxy holders will vote your proxy for such other candidate or candidates as may be nominated by our board of directors.

Who will count the votes?

A representative of our transfer agent, Computershare Trust Company, N.A., will tabulate the votes and act as inspector of election.

Who will bear the cost of soliciting votes for the annual meeting?

We will pay the entire cost of preparing, assembling, printing, mailing, and distributing these proxy materials and soliciting votes. If you choose to access the proxy materials and/or vote over the Internet, you are responsible for Internet access charges you may incur. If you choose to vote by telephone, you are responsible for telephone charges you may incur. In addition, the solicitation of proxies or votes may be made in person, by telephone, or by electronic communication, by our directors, officers, and employees. None of those directors, officers or employees will receive any additional compensation for such solicitation activities. We may also reimburse brokerage firms, banks, and other nominee holders of record for the cost of forwarding proxy materials to beneficial owners.

Where can I find the voting results of the annual meeting?

We will announce preliminary voting results at the annual meeting. We will also disclose voting results on a Current Report on Form 8-K to be filed with the SEC within four business days after the annual meeting. If final voting results are not available to us in time to file a Current Report on Form 8-K, we will file a Current Report on Form 8-K to publish preliminary results and, within four business days after final results are known, file an additional Current Report on Form 8-K to publish the final results.

What is householding and how does it affect me?

We have adopted a procedure called householding, which has been approved by the SEC. Under this procedure, we deliver only one copy of the Notice of Internet Availability, or proxy materials, if applicable, to multiple stockholders who share the same address and have the same last name, unless we have received contrary instructions from an affected stockholder. This procedure reduces our printing costs, mailing costs, and fees. Stockholders who participate in householding will continue to be able to access and receive separate proxy cards.

We will deliver, promptly upon written or oral request, a separate copy of the Notice of Internet Availability and/or the proxy materials, as applicable, to any stockholder at a shared address to which a single copy of the Notice of Internet Availability and/or the proxy materials, as applicable, were delivered. To receive a separate copy of the Notice of Internet Availability and/or the proxy materials, as applicable, you may write to or call our Investor Relations Department at 14185 Dallas Parkway, Suite 300, Dallas, Texas 75254, telephone (972) 391-5000. Any such request should be made promptly in order to ensure timely delivery. Any stockholders of record who (i) share the same address and currently receive multiple copies of the Notice of Internet Availability or proxy materials, as applicable, and (ii) wish to receive only one copy of the Notice of Internet Availability or proxy materials, as applicable, per household in the future may contact our Investor Relations Department at the address or telephone number listed above to participate in the householding program.

A number of brokerage firms have instituted householding. If you hold your shares beneficially in street name, please contact your bank, broker, or other holder of record to request information about householding.

What is the deadline to propose actions for consideration at next year s annual meeting of stockholders or to nominate individuals to serve as directors?

Requirements for Stockholder Proposals to be Considered for Inclusion in Our Proxy Materials

Stockholders may present proper proposals for inclusion in our proxy statement and for consideration at the next annual meeting of stockholders by submitting their proposals in writing to our corporate secretary in a timely manner. For a stockholder proposal to be considered for inclusion in our proxy statement for our 2013 annual meeting of stockholders, our corporate secretary must receive the written proposal at our principal executive offices not later than September 4, 2013; *provided, however*, that in the event that we hold our 2013 annual meeting of stockholders more than 30 days from the one-year anniversary date of the 2013 annual meeting, we will disclose the new deadline by which stockholders proposals must be received under Item 5 of our earliest possible Quarterly Report on Form 10-Q or, if impracticable, by any means reasonably calculated to inform stockholders. All stockholder proposals must otherwise comply with the requirements of Rule 14a-8 of the Securities Exchange Act of 1934, as amended, regarding the inclusion of stockholder proposals in company-sponsored proxy materials. Proposals should be addressed to:

Copart, Inc.
Attn: Corporate Secretary
14185 Dallas Parkway, Suite 300
Dallas, Texas 75254

The submission of a stockholder proposal does not guarantee that it will be included in Copart s proxy statement or proxy.

Requirements for Stockholder Proposals to be Brought Before the 2013 Annual Meeting

Our bylaws also establish an advance notice procedure for stockholders who wish to present a proposal before an annual meeting of stockholders, but do not intend for the proposal to be included in our proxy statement. Our bylaws provide that the only business that may be conducted at an annual meeting is business that is (i) specified in our proxy materials with respect to such meeting, (ii) otherwise properly brought before the meeting by or at the direction of our board of directors, or (iii) properly brought before the meeting by a stockholder of record entitled to vote at the annual meeting who has delivered timely written notice to our corporate secretary, which notice must

contain the information specified in our bylaws. To be timely for our 2013 annual meeting of stockholders, our corporate secretary must receive the written notice at our principal executive offices:

not earlier than August 5, 2013, and

not later than the close of business on September 4, 2013.

In the event that we hold our 2013 annual meeting of stockholders more than 30 days before or after the one-year anniversary date of the 2012 annual meeting, then notice of a stockholder proposal that is not intended to be included in our proxy statement must be received not later than the close of business on the later of the following two dates:

the 90th day before such annual meeting: or

the 10th day following the day on which public announcement of the date of such meeting is first made.

If a stockholder who has notified us of his or her intention to present a proposal at an annual meeting does not appear to present his or her proposal at such meeting, we are not required to present the proposal for a vote at such meeting.

Nomination of Director Candidates

Our bylaws permit stockholders to nominate directors for election at an annual meeting of stockholders. To nominate a director, the stockholder must provide the information required by our bylaws. In addition, the stockholder must give timely notice to our corporate secretary in accordance with our bylaws, which, in general, require that the notice be received by our corporate secretary within the time period described above under Requirements for Stockholder Proposals to be Brought Before the 2013 Annual Meeting for stockholder proposals that are not intended to be included in our proxy statement.

In addition, it is the policy of our nominating and governance committee to consider recommendations for candidates to the board of directors from stockholders holding not less than one percent (1%) of the outstanding shares of our common stock continuously for at least twelve (12) months prior to the date of submission of the recommendation or nomination. Any such recommendations should include the nominee s name and qualifications for membership on our board of directors, and should be directed to our general counsel at our address set forth above for our corporate secretary. For additional information regarding stockholder recommendations for director candidates, please see the sections entitled Corporate Governance and Board of Directors Director Nomination Process and Corporate Governance and Board of Directors Considerations in Identifying and Evaluation Director Nominees.

Availability of Bylaws

A copy of our current bylaws may be obtained free of charge by written request to our Investor Relations Department c/o Copart, Inc., 14185 Dallas Parkway, Suite 300, Dallas, Texas 75254.

CORPORATE GOVERNANCE AND BOARD OF DIRECTORS

Board of Directors Composition, Meetings, and Board Committees

Our board of directors is currently comprised of eight members. Our bylaws permit our board to establish the authorized number of directors within a range from five to nine members, and eight directors are currently authorized.

All directors elected at an annual meeting are elected to serve from the time of election and qualification until the earlier of the next annual meeting of stockholders following such election or their resignation or removal. At each annual meeting of stockholders, the terms of each of our incumbent directors expire and all members of our board of directors are elected.

Fiscal 2012 Board Meetings

During fiscal 2012, our board of directors held seven meetings. Each of our directors attended or participated in 75% or more of the total number of meetings of our board of directors, and 75% or more of the meetings held by all committees of our board of directors on which he served during the past fiscal year.

Board Leadership Structure

Our board of directors believes that it is important to retain its flexibility to allocate the responsibilities of the positions of the chairman of our board and chief executive officer in a way that it believes is in our best interests. Currently, the roles of chairman of our board and chief executive officer have been separated by our board of directors. Willis J. Johnson is our executive chairman, and A. Jayson Adair is our chief executive officer. Our board believes that the separation of the offices of chairman and chief executive officer is appropriate at this time because it allows our chief executive officer to focus primarily on our business strategy, operations, and corporate vision while the chairman provides guidance to the chief executive officer, sets the agenda for board meetings, and presides over meetings of the full board. Our board s administration of risk oversight has not affected its leadership structure.

Director Independence

Of our incumbent directors, Messrs. Blunt, Cohan, Englander, Meeks, and Tryforos have each been determined by our board to be an independent director as that term is defined under the rules of The NASDAQ Stock Market LLC, or NASDAQ.

Our board of directors has not established categorical standards or guidelines to make director independence determinations but considers all relevant facts and circumstances. Our board based its determinations primarily on a review of the responses of the directors to questions regarding employment and compensation history, affiliations, family and other relationships, and on discussions with our directors. In making its independence determinations, our board considered transactions between us and entities associated with the directors or members of their immediate family. All identified transactions that appear to relate to us and a person or entity with a known connection to a director are presented to our board of directors for consideration. In making its determination that certain directors are independent, our board of directors considered the transactions in the context of the NASDAQ rules, the standards established by the SEC for members of audit committees, and the SEC and Internal Revenue Service standards for compensation committee members.

Oversight of Risk Management

Our board of directors role in our risk oversight process includes receiving regular reports from members of senior management on areas of material risk to us, including operational, financial, legal and regulatory, and strategic and reputational risks.

Our board s role in risk oversight is consistent with our board s leadership structure, with the chief executive officer and other members of senior management having responsibility for assessing and managing our risk exposure and our board and committees providing oversight in connection with those efforts. While our board has the ultimate oversight responsibility for our risk management policies and processes, the committees of our board also have responsibility for risk oversight with respect to certain matters.

Our audit committee oversees management of financial risk exposures, including the integrity of our accounting and financial reporting processes and controls. As part of this responsibility, our audit committee meets periodically with our independent auditors, our internal auditors, and our financial and accounting personnel to discuss significant financial risk exposures and the steps management has taken to monitor, control, and report these exposures. Additionally, our audit committee reviews significant findings prepared by our independent auditors together with management s responses as well as significant findings of our internal auditors. Our audit committee also oversees risk associated with related party transactions and business conduct compliance.

Our compensation committee considers the risks associated with our compensation policies and practices with respect to both executive compensation and employee compensation generally. Our management has reviewed with our compensation committee the compensation plans and programs that could have a material impact on us. The management review considered whether any of these plans or programs may encourage inappropriate risk-taking, whether any plan may give rise to risks that are reasonably likely to have a material adverse effect on us, and whether our management would recommend any changes to the plans. Our management also reviewed with our compensation committee risk-mitigating controls such as the degree of compensation committee and senior management oversight of each program and the level and design of internal controls over such programs.

Our nominating and governance committee oversees risks associated with our overall governance practices and the leadership structure of our board. Our board is kept informed of each committee s risk oversight and other activities via regular reports of the committee chairs to the full board.

Board Committees

Our board of directors maintains three standing committees: an audit committee, a compensation committee, and a nominating and governance committee. Each committee has a written charter, approved by our board of directors, outlining the principal responsibilities of the committee. Copies of the current committee charters are available in the Corporate Governance section of the Investor Relations page on our website at *www.copart.com*.

Our board committees are comprised as follows:

Director Name	**Audit Committee**	**Compensation Committee**	**Nominating and Governance Committee**
Matt Blunt	√		√
Steven D. Cohan	Chair	√	
Daniel J. Englander	√	Chair	Chair
James E. Meeks			√

Only directors deemed to be independent (see below) serve on the audit, compensation, or nominating and governance committees. However, our board may create special committees from time to time and our current employee directors or those deemed not to be independent under applicable rules and guidelines may be appointed to serve on those special committees, as our board may determine.

Audit Committee. Our audit committee is primarily responsible for (i) reviewing and approving the services performed by our independent registered public accounting firm, (ii) reviewing our consolidated financial statements, and (iii) reviewing reports concerning our accounting practices and systems of internal accounting procedures and controls. The purposes of our audit committee are, among other things, to:

oversee our accounting and financial reporting processes and audits of our consolidated financial statements;

assist our board in overseeing and monitoring: (i) the integrity of our consolidated financial statements; (ii) our internal accounting and financial controls; (iii) our compliance with legal and regulatory requirements; and (iv) our independent auditor s qualifications, independence, and performance;

prepare the audit committee report that the rules of the SEC require be included in our annual proxy statement;

provide our board with the result of its monitoring and any recommendations derived from such monitoring;

provide our board with additional information and materials as our audit committee may determine to be necessary to make our board aware of significant financial matters requiring board attention; and

function as our qualified legal compliance committee for the purposes of reviewing and discussing any reports concerning material violations submitted to it by our attorneys or our outside counsel.

Our audit committee held five meetings during fiscal 2012. Our audit committee acts under a written charter adopted and approved by our board of directors, which charter can be found at http://www.copart.com/c2/pdf/audit_cc.pdf.

The audit committee currently consists of Steven D. Cohan, Daniel J. Englander and Matt Blunt. Mr. Cohan is the chair of our audit committee. Our board of directors has determined that each of the members of our audit committee are independent directors as contemplated by the NASDAQ listing rules and the rules of the SEC relating to audit committee independence. Our board of directors has designated Mr. Cohan, the chairman of the committee, as an audit committee financial expert as defined in Item 401(h) of Regulation S-K promulgated by the SEC. This designation is a disclosure requirement of the SEC and does not impose upon Mr. Cohan any duties, obligations, or liabilities greater than that which would otherwise be imposed by virtue of his membership on our board or audit committee. In addition, this designation does not affect the duties, obligations, or liabilities of any other director or audit committee member. Our board of directors has determined that each audit committee member has sufficient knowledge in reading and understanding financial statements to serve on our audit committee.

Compensation Committee. Our compensation committee is generally responsible for, among other things, (i) assisting our board of directors in providing oversight of our compensation policies, plans and benefits programs and (ii) reviewing and approving, and, where appropriate, making recommendations to our board of directors regarding all forms of compensation to be provided to all of our employees, directors and consultants, including stock compensation and loans, and all bonus and stock compensation to all employees.

Our compensation committee held five meetings during fiscal 2012. Our compensation committee acts under a written charter adopted and approved by our board of directors, which charter can be found at http://www.copart.com/c2/pdf/compensation_cc.pdf.

The compensation committee currently consists of Daniel J. Englander and Steven D. Cohan. Mr. Englander is the chair of our compensation committee. Our board of directors has determined that each of the members of our compensation committee are (i) independent directors as contemplated by NASDAQ rules, (ii) outside directors as defined in Section 162(m) of the Internal Revenue Code of 1986, as amended (Code), and (iii) non-employee directors for purposes of Rule 16b-3 under the Exchange Act.

Nominating and Governance Committee. Our board of directors established the nominating and governance committee to ensure that our board is properly constituted to meet its fiduciary obligations to stockholders and that we have and follow appropriate governance standards. The committee is authorized to assist our board by identifying prospective director nominees, to select the director nominees for the next annual meeting of stockholders and to develop and recommend to our board governance principles applicable to us.

Our nominating and governance committee held two meetings during fiscal 2012. Our nominating and governance committee acts under a written charter adopted and approved by our board of directors, which charter can be found at http://www.copart.com/c2/pdf/nominating_governance_cc.pdf.

The nominating and governance committee consists of Daniel J. Englander, Matt Blunt and James E. Meeks. Mr. Englander is the chair of our nominating and governance committee. Our board of directors has determined that each of the members of our nominating and governance committee were and are (i) independent directors

as contemplated by NASDAQ rules, (ii) outside directors as defined in Section 162(m) of the Code, and (iii) non-employee directors for purposes of Rule 16b-3 under the Exchange Act.

Compensation Committee Interlocks and Insider Participation

The compensation committee of our board of directors consisted of Messrs. Cohan, Englander and Thomas W. Smith from August 1, 2011 until December 14, 2011 and Messrs. Cohan and Englander from December 14, 2011 through the end of fiscal 2012. No member of our compensation committee was, at any time during fiscal 2012, an officer or employee of Copart or any of our subsidiaries. In addition, no member of our compensation committee had any relationship requiring disclosure under Item 404 of Regulation S-K promulgated by the SEC at the time such committee member served as a board member and committee member. The disclosure with respect to Thomas W. Smith under the heading *Related Person Transactions* below occurred following the end of his term as a member of our board of directors.

No interlocking relationship, as described by the SEC, currently exists or existed during fiscal 2012 between any member of our compensation committee and any member of any other company s board of directors or compensation committee.

Considerations in Identifying and Evaluating Director Nominees

Our nominating and governance committee has established policies and procedures relating to the consideration of any individual recommended as a prospective director nominee from stockholders. Please see the section entitled *Director Nomination Process* below. The nominating and governance committee will consider candidates recommended by stockholders in the same manner as candidates recommended to the committee from other sources.

In its evaluation of director candidates, including the members of the board of directors eligible for reelection, our committee will consider the following:

The current size and composition of our board of directors and the needs of the board and its respective committees;

Factors such as character, integrity, judgment, diversity of experience, independence, area of expertise, corporate experience, length of service, potential conflicts of interest, other commitments and the like. Our committee evaluates these factors, among others, and does not assign any particular weighting or priority to any of these factors; and

Other factors that our committee may consider appropriate.

Any nominee for a position on the board must satisfy the following minimum qualifications:

The highest personal and professional ethics and integrity;

Proven achievement and competence in the nominee s field and the ability to exercise sound business judgment;

Skills that are complementary to those of the existing board;

The ability to assist and support management and make significant contributions to the company s success; and

An understanding of the fiduciary responsibilities required of a member of the board and the commitment of time and energy necessary to diligently carry out those responsibilities.

If our committee determines that an additional or replacement director is required, the committee may take such measures as it considers appropriate in connection with its evaluation of a director candidate, including candidate interviews, inquiry of the person or persons making the recommendation or nomination, engagement of an outside search firm to gather additional information, or reliance on the knowledge of the members of the committee, board or management.

Director Nomination Process

Our nominating and governance committee is responsible for, among other things, determining the criteria for membership to our board of directors and recommending candidates for election to the board of directors. It is the policy of our nominating and governance committee to consider recommendations for candidates to the board of directors from stockholders holding not less than one percent (1%) of the outstanding shares of our common stock continuously for at least twelve (12) months prior to the date of submission of the recommendation or nomination. Stockholder recommendations for candidates to the board of directors must be directed in writing to Copart, Inc., 14185 Dallas Parkway, Suite 300, Dallas, Texas 75254, Attention: General Counsel, and must include the candidate s name, home and business contact information, detailed biographical data, relevant qualifications, a signed letter from the candidate confirming willingness to serve, information regarding any relationships between the candidate and Copart, and evidence of the recommending stockholder s ownership of our stock. Such recommendations must also include a statement from the recommending stockholder in support of the candidate, particularly within the context of the criteria for board membership, including issues of character, integrity, judgment, diversity of experience, independence, area of expertise, corporate experience, length of service, potential conflicts of interest, other commitments and the like, and personal references. For details regarding the process to nominate a director directly for election to the board at an annual meeting of the stockholders, please see the section entitled Questions and Answers About the Proxy Materials and Annual Meeting *What is the deadline to propose actions for consideration at next year s annual meeting of stockholders or to nominate individuals to serve as directors? Nomination of Director Candidates.*

Director Attendance at Annual Meetings

Although we do not have a formal policy regarding attendance at stockholder meetings, our directors are encouraged to attend the annual meeting of stockholders. Seven of our directors attended our 2011 annual meeting of stockholders. Mr. Tryforos was not a director at the time of our 2011 annual meeting of stockholders and did not attend the 2011 annual meeting.

Stockholder Communications with our Board of Directors

Our board of directors recommends that stockholders who wish to communicate directly with our board should do so in writing. Our board of directors has approved the following procedure for stockholders to communicate with our directors. Mail can be addressed to directors in care of Copart, Inc., Attn: General Counsel, 14185 Dallas Parkway, Suite 300 Dallas, Texas 75254. All mail received will be logged in, opened and screened for security purposes. All mail, other than trivial or obscene items, will be forwarded. Trivial items will be delivered to our directors at the next scheduled board meeting. Mail addressed to a particular director will be forwarded or delivered to that director. Mail addressed to Outside Directors or Non-Management Directors will be forwarded or delivered to the chairman of our nominating and governance committee. Mail addressed to the Board of Directors will be forwarded or delivered to the chairman of our board and chief executive officer. Our General Counsel may decide in the exercise of his judgment whether a response to any stockholder communication is necessary.

This procedure does not apply to stockholder proposals submitted pursuant to our bylaws and Rule 14a-8 of the Exchange Act, as discussed in this proxy statement under the caption *What is the deadline to propose actions for consideration at next year s annual meeting of stockholders or to nominate individuals to serve as directors?*

COMPENSATION OF NON-EMPLOYEE DIRECTORS

Our directors play a critical role in guiding our strategic direction and overseeing our management. In connection therewith, our non-employee directors are eligible to receive cash and equity compensation. Each non-employee director receives an annual director s fee, payable in quarterly installments. The annual non-employee director s fee was $50,000 from August 1, 2011 until June 5, 2012; however, on June 5, 2012, our board increased the annual fee for non-employee directors to $70,000, payable in quarterly installments. Mr. Cohan, who serves as chairman of our audit committee, receives an additional annual fee of $10,000 for his services as chairman of our audit committee, payable in quarterly installments. In addition to cash compensation, pursuant to procedures previously adopted by our board of directors, each non-employee director (other than newly appointed non-employee directors) receives an annual option grant of 40,000 shares under our 2007 Equity Incentive Plan, which grant takes place on the date of our annual meeting of stockholders each year. Newly appointed non-employee directors are awarded an initial grant of shares at the time of appointment and are not eligible for an additional grant until the fiscal year following their appointment. The directors are also eligible for reimbursement of reasonable and necessary expenses incurred in connection with their attendance at board and committee meetings.

Mr. Johnson is an executive officer, though not considered one of our named executive officers. As an employee director he does not receive any cash, equity or other compensation for his service as a member of our board of directors. In that respect, we have not listed him in either table in this section of our proxy statement.

The following table presents information relating to total compensation paid or accrued for services rendered to us in all capacities by our non-employee directors for the fiscal year ended July 31, 2012.

Name	Fees Earned or Paid in Cash ($)	Option Awards ($)(1)	Total ($)
Matt Blunt	55,000	229,408	284,408
Steven D. Cohan	65,000	229,408	294,408
Daniel J. Englander	55,000	229,408	284,408
James E. Meeks	55,000	229,408	284,408
Thomas W. Smith (2)	25,000		25,000
Thomas N. Tryforos		249,276	249,276

(1) Amounts shown represent the aggregate grant date fair values of awards of stock options granted in fiscal 2012, which were computed in accordance with Financial Accounting Standards Board Accounting Standards Codification Topic 718, Stock Compensation, as amended, without regard to estimated forfeitures, or, with respect to re-priced options, the incremental fair value as computed in accordance with

FASB ASC Topic 718. There can be no assurances that the amounts disclosed will ever be realized. Assumptions used in the calculation of these amounts are included in Note 1, Summary of Significant Accounting Policies Stock Compensation to our consolidated financial statements included in our Annual Report on Form 10-K for the fiscal year ended July 31, 2012.

(2) Did not stand for reelection at the 2011 annual meeting.

As of July 31, 2012, the end of our 2012 fiscal year, the aggregate number of stock options outstanding for each non-employee director was as follows:

Name	Aggregate Number of Shares Underlying Options
Matt Blunt	120,000
Steven D. Cohan	300,000
Daniel J. Englander	240,000
James E. Meeks	324,168
Thomas N. Tryforos	40,000

Under procedures previously adopted by our board of directors, each member of our board of directors (other than newly appointed non-employee directors) receives an option grant of 40,000 shares of our common stock on the date of our annual stockholder meeting. On December 14, 2011, the date of our 2011 annual shareholder meeting, each of Messrs. Blunt, Cohan, Englander and Meeks were granted options to purchase 40,000 shares of our common stock under our 2007 Equity Incentive Plan as part of their annual board compensation for fiscal 2012, at an exercise price of $22.59 per share, which was the closing price of our common stock on the NASDAQ Global Select Market on the date of grant. Fifty percent (50%) of the shares subject to each option vest 12 months from the date of grant and 1/24th of the total number of shares underlying each option vest each month thereafter, such that the options will be fully vested two years from the date of grant. Vesting of the options may accelerate if any successor corporation does not assume the options in the event of a change in control.

In addition, on September 22, 2011, our board of directors exercised its discretion pursuant to the terms of our 2007 Equity Incentive Plan to accelerate the vesting of all unvested shares of our common stock subject to options held by Mr. Smith, effective upon the termination of his membership on our board. As of December 14, 2011, the date on which Mr. Smith ceased to be a member of our board, Mr. Smith held options to acquire 80,000 shares of our common stock, of which 10,000 were otherwise unvested. In addition, our board approved amendments to outstanding option agreements with Mr. Smith to extend the period in which he will be able to exercise his stock options until the earlier of the fifth anniversary of Mr. Smith s termination as a director or the date the option would otherwise have terminated by its terms assuming he had continued to serve as a member of our board.

PROPOSAL NUMBER ONE

ELECTION OF DIRECTORS

General

One of the purposes of our annual meeting is to elect directors to hold office until the 2013 annual meeting of stockholders or until their respective successors are elected and have been qualified. At each annual meeting of stockholders, the terms of each of our incumbent directors expires and all members of our board of directors are elected. Our bylaws permit our board to establish the authorized number of directors within a range from five to nine members. Eight directors are currently authorized.

Nominees

Our nominating and governance committee has nominated the eight individuals listed below for election as directors, including Thomas N. Tryforos who was appointed by our board of directors in June 2012. All of the nominees for election at the annual meeting are currently our directors. All of the nominees were approved by our nominating and governance committee. Each person nominated for election has agreed to serve if elected, and we have no reason to believe that any nominee will be unavailable to serve. Unless otherwise instructed, the proxy holders will vote all submitted proxies FOR the eight nominees named below. In the event that additional persons are nominated for election as directors, the proxy holders intend to vote all proxies received by them in such a manner (in accordance with cumulative voting) as will ensure the election of as many of the nominees listed below as possible. In such event, the specific nominees to be voted for will be determined by the proxy holders. Directors must be elected by a plurality of the votes cast at the annual meeting. Accordingly, the eight candidates receiving the highest number of affirmative votes of the shares entitled to vote at the annual meeting will be elected to our board of directors.

Each of the following nominees is currently one of our directors. Please see Biographical Information below for information concerning each of the following directors standing for election. Please note that all ages set forth below are as of October 9, 2012.

Name	Age	Position	Director Since
Willis J. Johnson	65	Chairman of the Board	1982
A. Jayson Adair	42	Chief Executive Officer and Director	1992
Matt Blunt	41	Director	2009
Steven D. Cohan	51	Director	2004
Daniel J. Englander	43	Director	2006
James E. Meeks	63	Director	1996
Vincent W. Mitz	49	President	2011
Thomas N. Tryforos	54	Director	2012

Biographical Information

Willis J. Johnson, founder of Copart, has, since January 2004, served as chairman of our board of directors. From 1982 until February 2010, Mr. Johnson served as our chief executive officer and from 1986 until 1995, he also served as our president. Mr. Johnson was an officer and director of U-Pull-It, Inc. (UPI), a self-service auto dismantler, which he co-founded, from 1982 through September 1994. Mr. Johnson sold his entire interest in UPI in September 1994.

Mr. Johnson has over 30 years of experience in owning and operating auto dismantling companies and has overseen our growth from a single salvage facility in California to 156 salvage facilities in the United States, the United Kingdom, Canada and the United Arab Emirates. As such, he brings to our board significant institutional history as well as extensive knowledge of the industry and our operations.

A. Jayson Adair has served as our chief executive officer since February 2010. From November 1996 to February 2010, Mr. Adair served as our president. From 1995 until 1996, Mr. Adair served as our executive vice president. From 1990 until 1995, Mr. Adair served as our vice president of sales and operations, and from 1989 to 1990, Mr. Adair served as our manager of operations.

Mr. Adair s considerable knowledge and understanding of our company and our businesses together with his extensive experience managing crucial aspects of our business provide our board with significant insight into our businesses and operations.

Matt Blunt served as the Governor of the State of Missouri from 2005 to 2009. Prior to serving as the Governor of Missouri, Mr. Blunt served as a member of the Missouri General Assembly from 1999 through 2001 and as Missouri s Secretary of State from 2001 through his inauguration as Governor in 2005. Since leaving the Office of the Governor of the State of Missouri, Mr. Blunt has served as a senior advisor to government affairs and financial firms. Since February 2011, Mr. Blunt has served as the president of the American Automobile Policy Council, which represents the public policy interests of Chrysler Group, LLC, Ford Motor Company, and General Motors Company. He is a 1993 graduate of the United States Naval Academy and received four Navy and Marine Corps Achievement Medals during his military service as well as numerous other awards.

Mr. Blunt brings to our board extensive experience in government and public policy as a result of his service as the Governor of Missouri, a member of the Missouri General Assembly, and his military training. As such, he provides our board with a unique and broad perspective on the issues we face.

Steven D. Cohan has served as the chief executive officer and president and as a director of Loco Ventures, Inc., a privately held manufacturer of food products in Northern California, since 1997. From 1992 to 1994, he served as our vice president of finance and principal accounting officer and, from 1994 to 1996, he served as our vice president of corporate development. He holds an M.B.A. from the University of San Francisco and a B.A. in Economics from the University of California, Los Angeles. He is a certified public accountant.

Mr. Cohan brings to our board of directors a deep understanding of accounting principles and financial reporting rules and regulations. He acquired this knowledge in the course of serving as our principal accounting officer and his training as a certified public accountant.

Daniel J. Englander is managing partner of Ursula Capital Partners, an investment management firm that he founded in May 2004. In addition, since 2007, Mr. Englander has served as a director of America s Car-Mart, Inc., an automotive retailer based in Bentonville, Arkansas; and he served as a director of Ambassadors International, a cruise ship operator based in Seattle, Washington from 2009 through May 2011. From October 1994 until January 2004, Mr. Englander was employed as an investment banker with Allen & Company, a New York-based merchant bank, serving as a Managing Director from September 2002 until his departure. He holds a B.A. from Yale University.

Mr. Englander s background in investment management and finance enables him to be a valuable resource to our board and to our company with respect to financial and business issues.

James E. Meeks served as our chief operating officer from 1992, when he joined us in connection with our purchase of South Bay Salvage Pool, until his retirement in 2007. From 1995 to 1996, Mr. Meeks also served as our senior vice president and from 1996 until 2007 he served as our executive vice president. From 1986 to 1992, Mr. Meeks, together with his family, owned and operated the South Bay Salvage Pool, a salvage yard company. From 1991 to 2001, Mr. Meeks was an officer, director and part owner of CAS & Meeks, Inc., a towing and subhauling service company. On August 1, 2007, Mr. Meeks relinquished the titles and responsibilities of executive vice president and chief operating officer, and he retired from employment with us on December 31, 2007.

With over 30 years of experience in vehicle dismantling business and extensive experience in the subhauling business as well as his knowledge of our businesses and operations, Mr. Meeks brings to our board deep understanding of many aspects of the salvage market.

Vincent W. Mitz has served as our president since February 2010. From August 2007 to February 2010, Mr. Mitz served as our executive vice president. From May 1995 until July 2007, Mr. Mitz served as our senior

vice president of marketing. Previously, Mr. Mitz was employed by NER Auction Systems Inc. (NER), an automotive auction company, from 1981 until its acquisition by us in 1995. At NER, Mr. Mitz held numerous positions, most recently as Vice President of Sales and Operations for NER s New York region from 1990 to 1993 and Vice President of Sales & Marketing from 1993 to 1995.

With over 30 years of experience in the automotive auction industry, including 17 years with Copart, Mr. Mitz s understanding of our business, operations, and strategy enables him to provide significant insight into our business and operations.

Thomas N. Tryforos has been a private investor since 2005. Between May 1991 and September 2004, Mr. Tryforos was a General Partner at Prescott Investors, Inc., a private investment firm. Mr. Tryforos also serves as a director of Credit Acceptance Corporation, a publicly-traded indirect auto finance company. Mr. Tryforos received a B.A. from Columbia College in 1981. He received an MBA in accounting and finance from Columbia Business School in 1984.

Mr. Tryforos significant experience in investing and financial matters enables him to provide insight and be a valuable resource to our board of directors and our company with respect to investment and financial matters.

There are no family relationships among any of our directors or executive officers, except that A. Jayson Adair is the son-in-law of Willis J. Johnson.

Required Vote

The eight director nominees receiving the highest number of affirmative votes of the shares entitled to be voted at the annual meeting, either in person or by proxy, will be elected as directors at the annual meeting.

Recommendation of our Board of Directors

Our board of directors unanimously recommends that stockholders vote FOR the election of the eight nominees listed above.

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PROPOSAL NUMBER TWO

ADVISORY VOTE ON APPROVAL OF EXECUTIVE COMPENSATION

This year we are asking our stockholders to cast an advisory vote to approve the compensation of our named executive officers identified in the Fiscal Year 2012 Summary Compensation Table in the Executive Compensation section of this proxy statement as required by Section 14A of the Exchange Act. Section 14A was added to the Exchange Act by Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The advisory vote on the approval of executive compensation is a non-binding vote on the compensation of our named executive officers, as described in the *Compensation Discussion and Analysis* section, the tabular disclosure regarding such compensation, and the accompanying narrative disclosure, set forth in this proxy statement. The Dodd-Frank Act requires us to hold the advisory vote on the approval of execution compensation at least once every three years.

At our 2011 annual meeting of shareholders, we provided our shareholders with the opportunity to cast an advisory vote to approve the compensation of our named executive officers as disclosed in the proxy statement for our 2011 annual meeting of shareholders, and our shareholders overwhelmingly approved the proposal, with more than 98% of the votes cast in favor of the proposal to approve the executive compensation of our named executive officers. At our 2011 annual meeting of shareholders, we also asked our shareholders to indicate if we should hold an advisory vote to approve the compensation of our named executive officers every one, two, or three years, with our board of directors recommending an annual advisory vote. Because our board of directors views it as a good corporate governance practice, and because more than 92% of the votes cast were in favor of an annual advisory vote, we are again asking our stockholders to approve the compensation of our named executive officers as disclosed in this proxy statement.

Compensation Program and Philosophy

Our executive compensation program is designed to:

- to attract and retain talented and experienced executives;
- to motivate and reward executives whose knowledge, skills and performance are critical to our success; and
- to incentivize our executives to manage our business to meet our long-term objectives and the long-term objectives of our stockholders.

Under this program, our named executive officers are rewarded for the achievement of specific short-term and long-term goals that enhance stockholder value. Stockholders are urged to read the Compensation Discussion and Analysis section of this proxy statement, which describes our executive compensation program and contains information about the fiscal 2012 compensation of our named executive officers. Our compensation committee and our board of directors believe that our compensation design and practices are effective in implementing our executive compensation goals.

We are asking our stockholders to indicate their support for the compensation of our named executive officers as described in this proxy statement by voting in favor of the following resolution:

RESOLVED, that the stockholders approve, on an advisory basis in a non-binding vote, the compensation of Copart, Inc. s named executive officers as disclosed pursuant to Item 402 of Securities and Exchange Commission Regulation S-K, including the Compensation Discussion and Analysis, the compensation tables and narrative disclosures set forth in the proxy statement relating to Copart s 2012 annual meeting of stockholders.

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Required Vote

The affirmative FOR votes must exceed the votes cast AGAINST to approve, on an advisory basis, the compensation awarded to our named executive officers for the fiscal year ended July 31, 2012. You may vote FOR, AGAINST, or ABSTAIN on this proposal. Abstentions and broker non-votes are not counted as votes FOR or AGAINST this proposal.

Even though this say-on-pay vote is advisory and, therefore, will not be binding on us, our compensation committee and our board of directors value the opinions of our stockholders. Accordingly, to the extent there is a significant vote against the compensation of our named executive officers, we will consider our stockholders concerns, and our compensation committee will evaluate what actions may be necessary or appropriate to address those concerns.

Recommendation of our Board of Directors

Our board of directors unanimously recommends that stockholders vote FOR the approval of the compensation of our named executive officers as disclosed in this proxy statement.

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PROPOSAL NUMBER THREE

RATIFICATION OF APPOINTMENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

General

Our audit committee has appointed Ernst & Young LLP as our independent registered public accounting firm to audit our consolidated financial statements for the current fiscal year ending July 31, 2013. A representative of Ernst & Young LLP is expected to be present at the annual meeting, will have the opportunity to make a statement if he or she desires to do so, and will be available to respond to appropriate questions. Stockholder ratification of the appointment of Ernst & Young LLP is not required by our bylaws or otherwise. Our audit committee is submitting the appointment of Ernst & Young LLP to the stockholders for ratification as a matter of good corporate practice.

In the event our stockholders fail to ratify the appointment of Ernst & Young LLP, our audit committee will reconsider its selection. Even if the selection of the independent registered public accounting firm is ratified by our stockholders, our audit committee may, in its discretion, direct the appointment of a different independent registered public accounting firm at any time during the year if it feels that such a change would be in the best interests of the company and our stockholders.

Vote Required

The affirmative FOR votes must exceed the votes cast AGAINST to approve, on an advisory basis, the compensation awarded to our named executive officers for the fiscal year ended July 31, 2013. You may vote FOR, AGAINST, or ABSTAIN on this proposal. Abstentions are not counted as votes FOR or AGAINST this proposal.

Recommendation of our Board of Directors

Our board of directors unanimously recommends that stockholders vote FOR the ratification of the appointment of Ernst & Young LLP to serve as our independent registered public accounting firm for the fiscal year ending July 31, 2013.

* * * * *

Auditor Fees and Services

The following table sets forth the aggregate fees for professional services rendered for the audit of our consolidated annual financial statements by our independent registered public accounting firm, Ernst & Young LLP, for fiscal years ended July 31, 2012 and 2011. The table also includes fees billed for audit services, audit-related services, tax services and all other services rendered by Ernst & Young LLP for fiscal years ended July 31, 2012 and 2011:

Nature of Service	Fiscal Year 2012	Fiscal Year 2011
Audit Fees(1)	$1,534,300	$1,538,500
Audit-Related Fees(2)	$ 13,200	$ 26,500
Tax Fees(3)	$ 167,800	$ 175,100
All Other Fees(4)	$ 2,300	$ 2,000
Total Fees	$1,717,600	$1,742,100

(1) Audit fees consist of fees billed for professional services rendered for the audit of our consolidated financial statements and review of our interim consolidated financial statements included in quarterly reports and services that are normally provided in connection with statutory and regulatory filings or engagements.

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(2) Audit-related fees consist of fees billed for assurance and related services that are reasonably related to the performance of the audit or review of our consolidated financial statements and that are not reported under Audit Fees. These services include employee benefit plan audits, accounting consultations in connection with acquisitions, attest services that are not required by statute or regulation, and consultations concerning financial accounting and reporting standards.

(3) Tax fees consist of fees billed for professional services for tax compliance, tax advice and tax planning. These services include assistance regarding federal, state, and international tax compliance, tax audit defense, customs and duties, mergers and acquisitions, and international tax planning.

(4) Consists of fees for products and services other than the services reported above.

Policy on Audit Committee Pre-Approval of Audit and Permissible Non-Audit Services of Independent Registered Public Accounting Firm

Our audit committee s policy is to pre-approve all audit and permissible non-audit services provided by the independent registered public accounting firm (or subsequently approving audit and permitted non-audit services in those circumstances where a subsequent approval is necessary and permissible). These services may include audit services, audit-related services, tax services and other services. Pre-approval is generally provided for up to one year. Our independent registered public accounting firm and management are required to periodically report to our audit committee regarding the extent of services provided by our independent registered public accounting firm in accordance with this pre-approval. Our audit committee may also pre-approve particular services on a case-by-case basis. In addition, the charter of our audit committee provides that our audit committee may delegate to one or more designated members the authority to pre-approve audit and permissible non-audit services, provided such pre-approval decision is presented to our audit committee at its scheduled meetings.

Report of the Audit Committee

The audit committee of Copart s board of directors consists of Messrs. Cohan, Englander and Blunt. The audit committee has reviewed and discussed with management and Ernst & Young LLP Copart s audited consolidated financial statements and financial reporting processes. Copart s management has the primary responsibility for Copart s financial statements and financial reporting processes, including the system of internal controls. Ernst & Young LLP, Copart s current independent registered public accounting firm, is responsible for performing an independent audit of Copart s consolidated financial statements and for expressing an opinion on the conformity of those financial statements with generally accepted accounting principles. The audit committee reviews and monitors these processes and receives reports from Ernst & Young LLP and management. The audit committee also discusses with Ernst & Young LLP the overall scope and plans of their audits, their evaluation of our internal controls, and the overall quality of Copart s financial reporting processes.

In accordance with the statement on Auditing Standards No. 61, as amended (AICPA, *Professional Standards*, Vol. 1. AU section 380), as adopted by the Public Company Accounting Oversight Board (PCAOB) in Rule 3200T, the audit committee had discussions with management and the independent registered public accounting firm regarding the acceptability and the quality of the accounting principles used in the reports. These discussions included the clarity of the disclosures made therein, the underlying estimates and assumptions used in the financial reporting, and the reasonableness of the significant judgments and management decisions made in developing the financial statements. In addition, the audit committee has discussed with the independent registered public accounting firm their independence from Copart and its management and the independent registered public accounting firm provided the written disclosures and the letter required by the Public Company Accounting Oversight Board Rule 3526, Communication with Audit Committees Concerning Independence and considered the compatibility of non-audit services with the independent registered public accounting firm s independence.

On an annual basis, the audit committee obtains from the independent registered public accounting firm a written communication delineating all their relationships and professional services as required by The Public Company Accounting Oversight Board (PCAOB) Rule 3526, Communication with Audit Committees Concerning Independence. In addition, the audit committee reviewed with the independent registered public accounting firm the nature and scope of any disclosed relationships or professional services and took, or recommended that Copart s

board of directors take, appropriate action to ensure the continuing independence of the independent registered public accounting firm.

Based upon the reviews, discussions and considerations referred to above, the audit committee has recommended to the board of directors that Copart s audited consolidated financial statements be included in Copart s Annual Report on Form 10-K for fiscal year 2012, and that Ernst & Young LLP be appointed as the independent registered public accounting firm for Copart for the fiscal year ending July 31, 2013.

Respectfully submitted by:

The audit committee of the board of directors

Steven D. Cohan (chairman)
Daniel J. Englander
Matt Blunt

The preceding report of the audit committee shall not be deemed to be soliciting material or to be filed with the SEC or subject to Regulation 14A or 14C (17 CFR 240.14a-1 through 240.14b-2 or 240.14c-1 through 240.14c-101), other than as provided in Item 407(d) of Regulation S-K, or to the liabilities of section 18 of the Exchange Act (15 U.S.C. 78r), except to the extent we specifically request that the information be treated as soliciting material or specifically incorporate it by reference into a document filed under the Securities Act or the Exchange Act. Such information will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act, except to the extent *that we specifically incorporate it by reference.*

EXECUTIVE OFFICERS

Our executive officers and their ages as of October 9, 2012 were as follows:

Name	Age	Position
Willis J. Johnson	65	Chairman of the Board
A. Jayson Adair	42	Chief Executive Officer and Director
Vincent W. Mitz	49	President
William E. Franklin	56	Senior Vice President and Chief Financial Officer
Paul A. Styer	56	Senior Vice President, General Counsel and Secretary
Robert H. Vannuccini	46	Senior Vice President, Sales
Russell D. Lowy	53	Senior Vice President and Chief Operating Officer
Thomas E. Wylie	61	Senior Vice President, Human Resources
Vincent J. Phillips	52	Senior Vice President and Chief Information Officer
Matthew M. Burgener	37	Senior Vice President, Marketing
Anthony F. Cristello	43	Senior Vice President, Business Development
Simon E. Rote	40	Vice President, Finance

Willis J. Johnson, founder of Copart, has, since January 2004, served as chairman of our board of directors. From 1982 until February 2010, Mr. Johnson served as our chief executive officer and from 1986 until 1995, he also served as our president. Mr. Johnson was an officer and director of U-Pull-It, Inc. (UPI), a self-service auto dismantler, which he co-founded, from 1982 through September 1994. Mr. Johnson sold his entire interest in UPI in September 1994.

A. Jayson Adair has served as our chief executive officer since February 2010. From November 1996 to February 2010, Mr. Adair served as our president. From 1995 until 1996, Mr. Adair served as our executive vice president. From 1990 until 1995, Mr. Adair served as our vice president of sales and operations, and from 1989 to 1990, Mr. Adair served as our manager of operations.

Vincent W. Mitz has served as our president since February 2010. From August 2007 to February 2010, Mr. Mitz served as our executive vice president. From May 1995 until July 2007, Mr. Mitz served as our senior vice president of marketing. Previously, Mr. Mitz was employed by NER Auction Systems Inc. (NER), an automotive auction company, from 1981 until its acquisition by Copart in 1995. At NER, Mr. Mitz held numerous positions, most recently as Vice President of Sales and Operations for NER s New York region from 1990 to 1993 and Vice President of Sales & Marketing from 1993 to 1995.

William E. Franklin has served as our senior vice president and chief financial officer since March 2004. Mr. Franklin has over 20 years of international finance and executive management experience. From October 2001 to March 2004, Mr. Franklin served as the Chief Financial Officer of Ptek Holdings, Inc., an international telecommunications company. Prior to that he was the President and CEO of Clifford Electronics, an international consumer electronics company. Mr. Franklin received a Master s degree in Business Administration from the University of Southern California and his Bachelor of Science degree in Finance from California State University, Bakersfield. Mr. Franklin is a certified public accountant.

Paul A. Styer has served as our general counsel since September 1992, our corporate secretary since October 1993, and our senior vice president since April 1995. From September 1992 until April 1995, Mr. Styer served as our vice president. Mr. Styer served as one of our directors from September 1992 until October 1993. From August 1990 to September 1992, Mr. Styer conducted an independent law practice. Mr. Styer received a B.A. from the University of California, Davis and a J.D. from the University of the Pacific. Mr. Styer is a member of the State Bar of California.

Robert H. Vannuccini has served as our senior vice president, sales since July 2007. From 1999 to 2007, Mr. Vannuccini served as our vice president of national accounts. From 1995 to 1999, Mr. Vannuccini served as our Midwest Regional Account Manager. Prior to that, Mr. Vannuccini was employed by NER as the Midwest

Regional Account Manager from 1994 until its acquisition by Copart in 1995. Prior to his experience at NER, Mr. Vannuccini was an Assistant Vice President with Fleet Financial Group, a northeastern bank that was acquired by Bank of America, N.A. in 2004, from 1991 to 1994. Mr. Vannuccini received his Bachelor of Business Administration degree in Banking and Finance from Hofstra University, Hempstead, New York in 1988.

Russell D. Lowy has served as our senior vice president and chief operating officer since July 2007. From July 2002 to July 2007, Mr. Lowy served as our senior vice president of operations. Mr. Lowy served as our vice president of operations, eastern division from December 1999 to July 2002. From December 1998 to December 1999, Mr. Lowy served as our director of training and auditing. Mr. Lowy served as our assistant vice president of operations from 1996 to 1997, regional manager of northern California from 1995 to 1996, and marketing manager from 1993 to 1994. Prior to joining us, Mr. Lowy spent nine years with ADP   Claims Solutions Group, a provider of computing services to automobile dealers. Mr. Lowy received a B.S. in Business Administration from California State University, Chico in 1982.

Thomas E. Wylie has served as our senior vice president, human resources since November 2003. Mr. Wylie has over 25 years of human resources and organizational change management experience. From January 2001 to November 2003 he served as Vice President, Human Resources, Systems and Administration for the California Division of Kaiser Permanente, a health care organization headquartered in Oakland, California. Prior to that he was the Vice President of Human Resources for Global Business Services, a division of Honeywell International Inc. (Honeywell), a diversified technology and manufacturing company, in Morristown, New Jersey. He held several other positions with Honeywell starting in 1979. Mr. Wylie received a Bachelor s degree from Hamline University in St. Paul, Minnesota.

Vincent J. Phillips has served as our senior vice president and chief information officer since April 2010. Prior thereto in 2009, Mr. Phillips was Vice President of Product Development of Charles River Development, a provider of technology systems and services to the financial industry. From 1989 to 2008, Mr. Phillips was employed by The Charles Schwab Corporation, an online trading and investing company, most recently as Chief Executive Officer of its subsidiary, Cybertrader, Inc. Mr. Phillips received a Bachelor s degree from the University of California, San Diego.

Matthew M. Burgener has served as our senior vice president, marketing since July 2011. Mr. Burgener has over 12 years of digital marketing and ecommerce experience. From 2008 to July 2011, he was Senior Vice President of Digital Marketing at Bank of America, N.A., and from 2006 to 2007, Mr. Burgener was the Vice President, eCommerce Sales and Fulfillment at Bank of America, N.A. From 2004 to 2006, Mr. Burgener was the Senior Marketing Manager for LendingTree, LLC, an online home mortgage marketplace. Mr. Burgener received a Master s degree in Business Administration from the University of Virginia s Darden School of Business and a Bachelor s degree from Colby College.

Anthony F. Cristello has served as our senior vice president, business development since March 2012. From January 2010 to February 2012, Mr. Cristello served as Managing Director-*Head of Consumer Research Group* at BB&T Capital Markets (BBT), a part of BB&T Corporation, publicly traded financial services holding company. From April 2005 to December 2009, Mr. Cristello served as Senior Vice President, *Equity Analyst* at BBT and from November 2000 through April 2005, he served as Vice President, *Equity Analyst* at BBT. Mr. Cristello received a Bachelor s degree from Virginia Commonwealth University.

Simon E. Rote has served as our vice president of finance since March 2003. Prior thereto, Mr. Rote served as our controller from December 1998 to March 2003, and as our assistant controller from December 1997 to December 1998. Mr. Rote was an auditor with KPMG LLP, an auditing and tax advisory firm, from 1994 to 1997. Mr. Rote received a B.S. in Accounting from St. Mary s College in 1994.

Our executive officers are elected by our board of directors and serve at the discretion of our board. There are no family relationships among any of our directors or executive officers, except that A. Jayson Adair is the son-in-law of Willis J. Johnson.

EXECUTIVE COMPENSATION

Forward-Looking Statements

This proxy statement, including the section entitled Compensation Discussion and Analysis set forth below, contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Exchange Act. These statements are based on our current expectations and involve risks and uncertainties, which may cause our actual results to differ materially from those anticipated by forward-looking statements. The forward-looking statements may include statements regarding actions to be taken by us in the future. We undertake no obligation to publicly update any forward-looking statement, whether as a result of new information, future events, or otherwise. Forward-looking statements should be evaluated together with the many uncertainties that affect our business, particularly those mentioned in the section on forward-looking statements and in the risk factors in Item 1A of our Annual Report on Form 10-K for the fiscal year ended July 31, 2012 and in our periodic reports on Form 10-Q and current reports on Form 8-K as filed with the SEC.

Compensation Discussion and Analysis

Overview of Executive Compensation Programs

This section of our proxy statement provides an overview of our executive compensation programs, the material decisions we have made with respect to each element of our executive compensation program, and the material factors we considered when making those decisions. Following this discussion, you will find further information in the executive compensation tables about the compensation earned by or paid to each of our named executive officers, including details of fiscal 2012 compensation of our named executive officers in the Fiscal Year 2012 Summary Compensation Table. Currently, we have twelve executive officers, five of which are our named executive officers. For fiscal 2012, our named executive officers consist of (i) our chief executive officer, (ii) our chief financial officer, and (iii) our three most highly compensated executive officers other than our chief executive officer and chief financial officer, each of whom was serving as an executive officer on July 31, 2012, the end of our 2012 fiscal year. For fiscal 2012, our named executive officers were A. Jayson Adair, our chief executive officer; William E. Franklin, our chief financial officer; Vincent W. Mitz, our president; Robert H. Vannuccini, our senior vice president, sales; and Russell D. Lowy, our senior vice president and chief operating officer.

Role of Our Compensation Committee

The compensation committee of our board of directors administers our executive compensation programs. The compensation committee seeks to ensure that the total compensation paid to our executive officers is fair and reasonable, and serves the best interests of Copart and our stockholders. In carrying out its responsibilities, the committee:

- participates in the continuing development of, and reviews and approves changes in, our compensation policies;
- reviews and approves each element of executive compensation, taking into consideration management recommendations; and
- administers our equity incentive plans, for which it retains authority to approve grants of awards to any of our executive officers.

Our compensation committee consisted of Messrs. Cohan, Englander and Thomas W. Smith from August 1, 2011 until December 14, 2011 and Messrs. Cohan and Englander from December 14, 2011 through the end of fiscal 2012. Our board of directors has determined that each of the foregoing members of the compensation committee were or are an independent director under NASDAQ rules, an outside director for purposes of Section 162(m) of the Internal Revenue Code, and a non-employee director for purposes of Rule 16b-3 under the Exchange Act.

Our compensation committee operates according to a charter that details its specific duties and responsibilities. A copy of the charter is available in the Investor Relations section of our corporate website at http://www.copart.com/c2/pdf/compensation_cc.pdf.

Role of Management in Compensation Process

Our chief executive officer, president, chief financial officer, and senior vice president of human resources support our compensation committee s work by providing our compensation committee with information related to our financial plans, performance assessments of our executive officers, and other personnel-related data.

Each executive officer participates in our annual goal-setting and performance measurement process applicable to all employees. As part of this annual process, each executive officer proposes qualitative, individual goals and objectives for the coming fiscal year that are intended to promote continuing organizational and process improvements and contribute to our financial strength. These proposed goals are then reviewed with each executive officer, and are subsequently approved following that review, by our chief executive officer and our president. Our compensation committee does not participate in the setting of qualitative goals and objectives for our executive officers. Each officer s goals are specifically tailored to his or her function and may vary from year to year. Our chief executive officer, as the person to whom our other officers directly report, is responsible for evaluating individual officers contributions to corporate objectives as well as their performance relative to individual objectives. Assessment of individual performance may include objective criteria, such as the execution of projects in a timely manner, but is largely subjective.

Following the end of each fiscal year and after the completion of the performance measurement process described above, our chairman and chief executive officer make recommendations to our compensation committee with respect to all elements of compensation for each of our executive officers other than themselves. Our compensation committee then discusses these recommendations, first with the chairman and chief executive officer present and then in executive session without members of management present. Members of management do not participate in final determinations of their own compensation. Our compensation committee is solely responsible for the final approval of all forms of executive compensation and, while the committee considers the recommendations of management, it does not always follow those recommendations.

Our compensation committee has the authority under its charter to engage the services of outside advisors for assistance. Our compensation committee has neither relied on nor has it retained outside advisors for purposes of making determinations with respect to executive compensation.

Compensation Philosophy and Program Design

The principal objectives of our compensation and benefits programs for executive officers are to:

attract and retain senior executive management;

motivate their performance toward corporate objectives; and

align their long-term interests with those of our stockholders.

Our compensation committee believes that maintaining and improving the quality and skills of our management team and appropriately providing incentives for their performance are critical factors that will affect the long-term value realized by our stockholders.

As further described below, compensation for our executive officers has historically consisted of four main elements: base salary, cash bonus, equity-based incentive awards, and benefits and perquisites. Other than with respect to Mr. Adair, whose equity compensation program is described below, our compensation committee has not adopted any formal or informal policies or guidelines for allocating compensation between cash and equity compensation or among different forms of non-equity compensation for our executive officers. Our compensation committee believes that a substantial portion of an executive officer s compensation should be performance-based, whether in the form of cash bonus or equity compensation. We consider performance-based compensation to be the portion of an executive s total compensation that is determined based on the executive s individual contribution

to our strategic goals and operating results, as in the case of discretionary cash bonuses and equity awarded in recognition of individual performance. As discussed below, Mr. Adair s compensation program is entirely performance based as his ability to realize any material compensation from us during the five year period from April 2009 to April 2014 depends on the price performance of our common stock. Our other executive officers also participate in our equity compensation programs, and we have historically paid discretionary cash bonuses based principally on the recommendation of our chief executive officer and largely subjective reviews by our compensation committee of corporate and individual performance.

Historically, we have not determined our compensation levels based on specific peer company benchmarks or analyses prepared by outside compensation consultants. Rather, our compensation committee has based its determinations on the committee s collective assessment of quantitative as well as subjective factors relating to corporate and individual performance and on the committee s experience and view of appropriate levels of compensation in light of our size and operating budgets, the historically increasing scope of our operations, including its increased geographic scope, and the responsibilities and performance of the individual officer.

Our compensation committee traditionally makes its determinations concerning base salary, cash bonuses and additional equity incentive awards annually after the end of each fiscal year, based on a review of our financial performance during the prior fiscal year as measured against the operating plan approved by the board of directors for the applicable fiscal year, each individual officer s contribution toward that performance, and the recommendations of our chairman and chief executive officer. Although the committee has historically not identified specific financial performance targets, its annual analysis has focused on quantitative factors such as trends in our revenues and earnings per share. Our compensation committee does not take a formulaic approach to setting compensation for our executive officers but does consider whether we have met or exceeded our operating plan for a particular fiscal year when making its determinations of appropriate levels of compensation for our executive officers. The committee also reviews subjective factors such as the growth in the scope of our operations, our performance in effectively integrating acquisitions, and our performance in implementing key corporate strategic initiatives.

Our compensation committee believes that our historic levels of executive compensation have been reasonable and appropriate in light of the size of our business, both financially and operationally, the substantial contribution of our long-tenured executive team in contributing to our historical growth, and the need to retain our key executive officers who have substantial levels of industry and Copart-specific experience. With the exception of our chief financial officer, each of our named executive officers has been employed with us for over a decade and with either us or a company we acquired for tenures ranging from 19 to over 30 years.

2011 Advisory Stockholder Vote on Executive Compensation

We value the opinions of our stockholders, and, as noted above, our compensation committee considers whether our executive compensation serves the best interests of our stockholders. In that respect, as part of its ongoing review of our executive compensation, the compensation committee considered the results of our 2011 say-on-pay vote. At our 2011 annual meeting of shareholders, more than 98% of the votes cast on the say-on-pay proposal were in favor of the executive compensation of our named executive officers described in last year s proxy statement. In light of this strong stockholder support, our compensation committee affirmed our general principles and objectives relating to executive compensation and continues to apply such principles and objectives to our executive compensation program.

Compensation of Mr. Adair

In 2008, Willis J. Johnson, then our chairman and chief executive officer, and Mr. Adair, then our president, presented our compensation committee with a proposal for a compensation arrangement in which they would forego all salary and bonus compensation other than $1.00 per year in exchange for a sizable stock option grant. In addition, they would agree to forego any additional equity incentives until the options were fully vested. Our compensation committee believed the proposal demonstrated an extraordinary senior management commitment to us and our stockholders and offered strong evidence of management s conviction concerning our strategy and prospects.

Over the course of the next several months, members of our compensation committee, individually among themselves and in periodic meetings, further discussed management s proposal concerning equity in lieu of cash and other equity compensation. Mr. Johnson and Mr. Adair participated in several, but not all, of these discussions. Among the factors discussed and considered by our compensation committee in making its final determination were the following:

- the extent to which the proposal achieved our compensation committee s objective of aligning management interests with stockholder interests;
- the accounting implications and associated non-cash compensation expense of the equity proposal as compared to the cash and non-cash compensation expense that would result from continuing current compensation arrangements;
- the impact of the equity proposal on our cash position relative to the anticipated impact of continuing current compensation arrangements; and
- the terms and conditions of the equity incentive, including whether it consisted of stock options or restricted stock and the vesting terms and conditions of the proposed equity issuance.

Following extensive analysis and discussions among our compensation committee member, our compensation committee met and approved a stock option in lieu of cash or additional equity compensation program on March 4, 2009. Specifically, subject to stockholder approval, our compensation committee and board of directors, excluding Mr. Johnson and Mr. Adair, approved the grant of a non-qualified stock option to each of Mr. Johnson and Mr. Adair on the following terms:

Number of Shares Subject to Option	4,000,000 (1) shares of our common stock for each of Mr. Johnson and Mr. Adair.
Exercise Price	Equal to the closing price of our common stock in trading on the NASDAQ Global Select Market on the date of grant.
Vesting	20% of the shares become exercisable on the first anniversary of the date of grant; the balance of the shares become exercisable on a monthly basis over 48 months at the rate of 66,666 shares per month.
Vesting Acceleration Triggers	Upon a termination of the officer s employment by us without cause (as defined) before or following a change in control or resignation for good reason (as defined) following a change in control, the option would become fully vested.
Option Term	10 years; provided that in the event of a voluntary termination (other than for good reason following a change-in-control) or involuntary termination for cause at any time, to the extent vested, within twelve (12) months of the date of termination.

(1) Throughout this proxy statement all share and per share amounts have been adjusted as appropriate to reflect our two-for-one stock split effected in the form of a stock dividend, which was distributed after close of trading on March 28, 2012 to stockholders of record as of March 23, 2012.

On April 14, 2009, our stockholders (with Messrs. Johnson and Adair abstaining from the vote) approved the equity grants for our chief executive officer and president described above, and each was granted an option to purchase 4,000,000 shares of our common stock on the terms and conditions set forth above with an exercise price of $15.11 per share, which equaled the fair market value of our common stock on the date of grant. As a result, Messrs. Johnson and Adair are not eligible to be considered for any additional compensation other than their salaries of $1.00 per year and appropriate benefits and perquisites during the five-year vesting term of the stock options.

Principal Components of Executive Compensation

The following discussion outlines the principal elements of executive compensation for our named executive officers other than Mr. Adair.

Base Salary

We pay an annual base salary to each of our executive officers (other than Messrs. Johnson and Adair) in order to provide them with a fixed rate of cash compensation during the year. Base salary for our executive officers reflects the scope of their respective responsibilities, seniority, and competitive market factors. Salary adjustments are determined by our compensation committee, generally following its review of recommendations from the chairman and chief executive officer. Any adjustments are made following consideration of competitive factors, our overall financial results, our budget requirements and the committee s assessment of individual performance.

2012 Base Salary. In October 2011, our compensation committee met to review base salaries for the named executive officers and approved base salaries for our named executive officers for fiscal 2012. At that meeting, the committee determined that it would not adjust current base salaries for fiscal 2012 given the committee s belief that existing base salaries remained competitive and appropriate. Moreover, the committee believes that each named executive officer s agreement to relocate to Texas with Copart evidenced their commitment and lack of retention issues. The committee also noted that we were offering favorable relocation benefits in connection with the move, including a home purchase program for executive officers.

2013 Base Salary. Our compensation committee met again in October 2012, in part to consider executive officer base salaries for fiscal 2013. At that meeting, the committee determined that it would increase base salaries because of the increased responsibilities with respect to international operations and increased unit volume in North America. The base salary increases were made retroactive to September 28, 2012. The compensation committee did not increase the base salary of Mr. Mitz as it determined the overall compensation package provided to him was competitive. The compensation committee did not rely on any formal compensation survey data in making its assessment.

The following table presents base salary information for the named executive officers for fiscal year 2012 and 2013:

Named Executive Officer	**2012 Base Salary**	**2013 Base Salary**	**Change**
A. Jayson Adair	$ 1	$ 1	
Vincent W. Mitz	$650,000	$650,000	
William E. Franklin	$310,000	$325,000	4.8%
Robert H. Vannuccini	$260,000	$275,000	5.8%
Russell D. Lowy	$275,000	$290,000	5.5%

Discretionary Cash Bonuses

Our annual discretionary cash bonus program for our officers and other employees is designed to reward performance that has furthered key corporate objectives, including financial objectives and those based on individual contributions to strategic initiatives.

We did not adopt a formal bonus plan for or during fiscal 2012 and do not expect to adopt any formal program for fiscal 2013. As a result, for fiscal 2012, our bonus program consisted of discretionary bonuses as determined by our compensation committee. In October 2012, as part of its annual review of executive compensation, our compensation committee met to consider cash bonus awards for our named executive officers.

We believe the use of a discretionary bonus program provides our compensation committee with the flexibility needed to address pay-for-performance as well as recruiting and retention goals. The amount of a discretionary bonus, if any, to be awarded to an executive officer is based on our compensation committee s review of individual and corporate performance and the recommendations of our chief executive officer.

In determining 2012 cash bonus awards for our named executive officers (other than Mr. Adair), our compensation committee considered individual contributions to corporate financial and business performance during fiscal 2012, including our operating results, expense management initiatives, and corporate business development projects. For the benefit of the committee, Mr. Adair reviewed each individual officer s performance relative to the categories, with specific discussion of how individual functional areas contributed to the larger corporate strategic objectives. Mr. Mitz s performance was principally evaluated by our compensation committee with respect to objectives relating to development of our strategic goals and performance objectives for our executive officers as well as his role in reducing expenses and developing the Company s programs to increase revenues across all areas of our business. Mr. Franklin s performance was principally evaluated with respect to objectives relating to the development of associates in our corporate finance function, financial reporting to the board, audit committee, and expense management. Mr. Vannuccini s performance was evaluated with respect to revenue growth. Mr. Lowy s performance was evaluated largely with respect to factors relating to facility condition, management of new accounts, and cost control at our facility level and per car detail, as well as his ability to reduce expenses of our field operations and administer and manage the field operations budget. The compensation committee determined that the increase in bonus amounts from fiscal 2011 were appropriate in light of recommendations made by the chief executive officer with respect to reviews of the individual performance of each named executive officer, increased responsibilities of each named executive officer with respect to international operations and unit volume in North America and the lack of equity grants for fiscal 2012.

Based on its review of these factors with our chief executive officer the compensation committee approved the following cash bonuses for our named executive officers:

Named Executive Officer	Fiscal Year 2012 Cash Bonus Amount
A. Jayson Adair	
Vincent W. Mitz	$600,000
William E. Franklin	$316,778
Russell D. Lowy	$280,540
Robert H. Vannuccini	$370,506

Equity-Based Incentives

We grant equity-based incentives to certain employees, including our executive officers, in order to foster a corporate culture that aligns employee interests with stockholder interests. Our equity incentive plans have provided the principal method for our executive officers to acquire an equity position in our company. Following approval by the stockholders of the option grant to Mr. Adair, our compensation committee deemed him ineligible to be awarded any additional equity compensation for the five year period ending on April 14, 2014.

While we have not adopted any specific stock ownership guidelines for our executive officers or directors, our executive officers and directors do own a substantial portion of our common stock. As part of our insider trading policy we prohibit any member of the board of directors, officer, employee, consultant or other person associated with us from trading in any interest or position relating to the future price of our securities, such as a put, call or short sale, or using our stock as collateral for margin loans.

Only our compensation committee is authorized to grant awards to our executive officers under our equity incentive plans. With respect to executive officers, our practice has been to grant options to executive officers on an annual basis as part of the annual review process immediately after the end of each fiscal year, although we have not always granted annual option awards to our executive officers. Generally, in making its determination concerning additional option grants, our compensation committee considers individual performance, competitive factors, the individual s current level of compensation and equity participation, and the recommendations of our chairman and chief executive officer.

To date, our equity incentive awards to executive officers have been granted primarily with time-based vesting. Our option grants typically vest over a five-year period with 20% of the shares vesting on the one-year anniversary of the date of grant and the remaining shares vesting in equal monthly installments over the remaining four years. Although our practice in recent years has been to provide equity incentives to executives in the form of stock option

grants that vest over time, our compensation committee may in the future consider alternative forms of equity grants, such as performance shares, restricted stock units, restricted stock awards or other forms of equity grants as allowed under our 2007 Equity Incentive Plan, with vesting of awards based on the achievement of performance milestones or financial metrics.

Generally, our compensation committee considers, and, if it determines appropriate, approves option grants for our executive officers following the end of each fiscal year. Our compensation committee determines the size of these grants based on a number of subjective factors, including the individual executive officer s contribution to our performance in the prior fiscal year, and less subjective factors such as the relative vested versus unvested equity position of the individual executive.

In October 2012, as part of its annual review of executive compensation, our compensation committee determined that our named executive officers would not be granted stock options because of the option grants (including the amount thereof) made in fiscal 2011 and the relative vested versus unvested equity incentive positions of each of the named executive officers.

Benefits and Perquisites

We provide the following benefits to our named executive officers, including Mr. Adair, generally on the same basis provided to our other employees: health, dental and vision insurance, medical and dependent care flexible spending account, short- and long-term disability insurance, accidental death and dismemberment insurance, and a 401(k) plan. We match employee contributions to the 401(k) plan at a rate of 20% of the first 15% of earnings per employee, up to a maximum of $3,300 for fiscal 2012.

During a portion of fiscal 2012, we provided our chairman and chief executive officer with limited ability to use our corporate aircraft for personal purposes. Our compensation committee authorized Mr. Johnson and Mr. Adair to use the aircraft for personal purposes for up to a total of 75 flight hours per fiscal year, to be allocated between them as they deem appropriate. Hours not used during a fiscal year were to be carried over to the next fiscal year. Flight hours in excess of these amounts required the additional approval of our compensation committee. We valued this benefit for compensation purposes on an annual basis pursuant to guidelines established by the Internal Revenue Service, and Mr. Johnson and Mr. Adair remained responsible for all taxes resulting from any deemed income arising from this benefit. On April 3, 2012 and July 25, 2012, respectively, we sold our corporate aircraft to third parties in arms-length transactions and, therefore, we no longer provide this benefit to Mssrs. Johnson and Adair. However, we continue to provide Mr. Adair and Mr. Mitz with company-owned automobiles that may be used for personal purposes and Mr. Franklin, Mr. Lowy, and Mr. Vannuccini with a monthly automobile expense allowance.

Please see the column entitled All Other Compensation in the summary compensation table set forth in this proxy statement for the amounts attributable to each named executive officer with respect to benefits and perquisites.

Other Considerations:

Post-Employment Obligations

Each of our executives is an at will employee, and we are not party to written employment agreements with our named executive officers, other than with Mr. Franklin, our chief financial officer, whose agreement provides, under certain circumstances, for certain payments upon involuntary termination of employment or resignation for good reason (as defined in the agreement). In addition, we have entered into similar agreements with Thomas Wylie, our senior vice president of human resources, Vincent Phillips, our senior vice president of information technology, and Matthew Burgener, our senior vice president of marketing. Our compensation committee believes the terms of these agreements are fair and reasonable and are in our best interests and in the best interests of our stockholders. For a description of the material terms of these agreements, please see Employment Contracts and Severance Arrangements with Executive Officers in the section entitled Potential Post-Employment Payments Upon Termination or Change in Control included in this proxy statement.

Tax Deductibility of Compensation

Section 162(m) of the Code limits the tax deductibility of non-performance based compensation paid to our chief executive officer and to each of our four most highly compensated officers to $1 million per person, unless certain exemption requirements are satisfied. Exemptions to this deductibility limit may be made for various forms of performance-based compensation that are approved by our stockholders. Because our equity incentive plans have been approved by our stockholders, awards under these plans in excess of $1 million should generally be deductible pursuant to section 162(m), provided the requirements of section 162(m) are satisfied.

Section 409A of the Internal Revenue Code

Section 409A imposes additional significant taxes in the event an executive officer, director or other service provider for the company receives deferred compensation that does not satisfy the requirements of section 409A. Although we do not maintain a traditional deferred compensation plan, section 409A may apply to certain severance arrangements and equity awards. Consequently, to assist the affected employee in avoiding additional tax and penalties under section 409A, we developed the severance arrangements described above in Post-Employment Obligations to either avoid the application of section 409A or, to the extent doing so is not possible, comply with the applicable section 409A requirements.

Equity Grant Practices

In June 2007, our compensation committee and board of directors adopted a policy with respect to the grant of stock options and other equity incentive awards. Among other provisions, the policy generally prohibits the grant of stock option or other equity awards to executive officers during closed quarterly trading windows (as determined in accordance with our insider trading policy). In addition, the equity grant policy requires that all equity awards made to executive officers be approved at meetings of our compensation committee rather than by written consent of the committee.

REPORT OF THE COMPENSATION COMMITTEE

The compensation committee has reviewed and discussed with management the Compensation Discussion and Analysis contained in this proxy statement immediately above. Based on this review and discussion, the compensation committee has recommended to the board of directors that the Compensation Discussion and Analysis be included in this proxy statement and incorporated by reference into our Annual Report on Form 10-K for the fiscal year ended July 31, 2012.

COMPENSATION COMMITTEE
Daniel J. Englander (chairman)
Steven D. Cohan

The preceding report of the audit committee shall not be deemed to be soliciting material or to be filed with the SEC or subject to Regulation 14A or 14C (17 CFR 240.14a-1 through 240.14b-2 or 240.14c-1 through 240.14c-101), other than as provided in Item 407(d) of Regulation S-K, or to the liabilities of section 18 of the Exchange Act (15 U.S.C. 78r), except to the extent we specifically request that the information be treated as soliciting material or specifically incorporate it by reference into a document filed under the Securities Act or the Exchange Act. Such information will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act, except to the extent that we specifically incorporate it by reference.

Fiscal Year 2012 Summary Compensation Table

The following table sets forth information regarding all of the compensation awarded to, earned by, or paid to (i) our chief executive officer, (ii) our chief financial officer, and (iii) the three most highly compensated executive officers other than our chief executive officer and chief financial officer serving as executive officers as of July 31, 2012, the end of our 2012 fiscal year. We refer to these officers as the named executive officers.

Name and Principal Position	Fiscal Year	Salary ($)	Bonus ($)(1)	Option Awards ($)(2)	All Other Compen-sation ($)(3)	Total ($)
A. Jayson Adair	2012	1(4)			10,800(5)	10,801
Chief Executive Officer	2011	1(4)			71,018	71,019
	2010	1(4)			49,897	49,898
Vincent W. Mitz	2012	650,000	600,000		13,400(6)	1,263,400
President	2011	640,384	500,000	4,789,415	16,962	5,946,761
	2010	488,462	500,000	2,553,213	16,354	3,558,029
William E. Franklin	2012	310,000	316,778		10,550(7)	637,328
Senior Vice President and	2011	308,076	319,385	1,387,286(8)	9,300	2,024,047
Chief Financial Officer	2010	300,000	200,000(9)	718,215	9,300	1,227,515
Russell D. Lowy	2012	275,000	280,540		8,416(10)	563,956
Senior Vice President,	2011	270,192	207,551	1,393,780	6,841	1,878,364
Chief Operating Officer	2010	250,000	200,000	718,215	6,720	1,174,935
Robert H. Vannuccini*	2012	260,000	370,506		5,850(11)	636,356

Name and Principal Position	Fiscal Year	Salary ($)	Bonus ($)(1)	Option Awards ($)(2)	All Other Compen-sation ($)(3)	Total ($)
Senior Vice President, Sales	2011	253,269	211,962	1,684,378	172,581	2,322,190

* Mr. Vannuccini was not a named executive officer prior to fiscal 2011 and, in accordance with SEC guidance, no compensation information is included for fiscal 2010.

(1) The amounts in this column represent discretionary bonuses awarded for services performed during the applicable fiscal year. Annual bonuses earned during a fiscal year are generally paid in the first quarter of the subsequent fiscal year.

(2) There were no equity awards granted to named executive officers in fiscal 2012. For the number of outstanding equity awards held by the named executive officers as of July 31, 2012, see the Outstanding Equity Awards table in this proxy statement. Each equity award listed in this column was granted under the 2007 Equity Incentive Plan and will become exercisable for the option shares in installments over the executive s period of service with us. Options vest over a five-year period from the date grant, with the first 20% vesting on the one-year anniversary of the date of grant and the remainder vesting monthly thereafter. Each option has a maximum term of 10 years, subject to earlier termination in the event of the executive s termination of employment with us.

(3) We pay 401(k) matching contributions, life and health insurance and short-term disability premiums on behalf of all of our employees, including our named executive officers. The amounts shown in this column, other than the amounts for personal use of corporate aircraft discussed below, equal the actual cost to us of the particular benefit or perquisite provided. Amounts in this column include the cost to us of a named executive officer s (i) personal use of a company-owned automobile or (ii) an automobile expense allowance.

(4) For the period beginning on April 14, 2009 and ending on April 14, 2014, Mr. Adair receives $1 per year in salary.

(5) Includes $10,800 related to personal use of a company-owned automobile.

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(6) Includes $2,600 for 401(k) matching contribution paid by Copart on behalf of Mr. Mitz and $10,800 related to personal use of a company-owned automobile.

(7) Includes $3,300 for 401(k) matching contribution paid by Copart on behalf of Mr. Franklin and $7,250 related to an automobile allowance.

(8) Relates to options granted on October 4, 2010 with respect to 40,000 shares, options granted in March 4, 2011 with respect to 120,000 shares, together with the incremental value of the options granted on October 15, 2010 in lieu of the cash bonus for fiscal 2010, in each case, as reflected in the Grants of Plan-Based Awards table.

(9) Mr. Franklin declined the cash payout of this cash bonus award and instead received an option to purchase 80,000 shares of our common stock. The 80,000 share option grant is reflected in the Grants of Plan-Based Awards table. The grant date fair value of the option to purchase 80,000 shares of our common stock computed in accordance with ASC Topic 718 was $484,104. This amount does not reflect compensation actually received by Mr. Franklin, and there can be no assurances that the amount disclosed will ever be realized. Assumptions used in the calculation of these amounts are included in Note 1, Summary of Significant Accounting Policies Stock Compensation to our consolidated financial statements include in our Annual Report on Form 10-K for the fiscal year ended July 31, 2010.

(10) Includes $1,621 for 401(k) matching contribution paid by Copart on behalf of Mr. Lowy and $6,795 related to an automobile allowance.

(11) Includes $5,850 related to an automobile allowance.

For a description of the components of our executive compensation program, including the process by which salaries and bonuses are determined, please see the section entitled Compensation Philosophy and Program Design in the Compensation Discussion and Analysis section of this proxy statement. For a description of our cash bonus program, please see the section entitled Discretionary Cash Bonuses in the Compensation Discussion and Analysis section of this proxy statement.

We are not a party to any written employment agreements with any of our named executive officers, except for an employment agreement we entered into with William E. Franklin, our senior vice president and chief financial officer, in fiscal 2004 which was subsequently amended in September 2008 to comply with section 409A of the Internal Revenue Code. For a description of the material terms of Mr. Franklin s agreement with us, please see the section entitled Employment Contracts and Severance Arrangements with Executive Officers contained in this proxy statement.

Until our corporate aircraft were sold on April 3, 2012 and July 25, 2012, respectively, we provided our chairman and our chief executive officer limited ability to use our corporate aircraft for personal purposes, subject to the standards and limitations described under the caption Compensation Discussion and Analysis Benefits and Perquisites, in this proxy statement. For purposes of the summary compensation table above, consistent with SEC guidelines, we have valued this perquisite based on the incremental cost to us. For purposes of valuing personal use of corporate aircraft, we have used a method that takes into account (i) landing/parking/flight planning services and expenses; (ii) crew travel expenses; (iii) supplies and catering; (iv) aircraft fuel and oil expenses; (v) maintenance, parts and external labor; (vi) customs, foreign permit and similar fees, if any; and (vii) passenger ground transportation. Incremental cost does not include an allocable share of the fixed costs associated with our ownership of the aircraft.

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Outstanding Equity Awards at 2012 Fiscal Year End

The following table presents certain information concerning equity awards held by the named executive officers at the end of the fiscal year ended July 31, 2012. As noted above, throughout this proxy statement, including, without limitation, each of the tables herein, all share and per share amounts have been adjusted as appropriate to reflect our two-for-one stock split effected in the form of a stock dividend, which was distributed after close of trading on March 28, 2012 to all stockholders of record as of March 23, 2012.This table includes unexercised and unvested option awards. Each equity grant is shown separately for each named executive officer.

Named Executive Officer	Number of Securities Underlying Unexercised Options (#) Exercisable	Number of Securities Underlying Unexercised Options (#) Unexercisable	Option Grant Date (1)	Option Exercise Price ($)	Option Expiratio Date
A. Jayson Adair	386,667	13,333	9/28/2007	17.195	9/28/20
	153,333	46,667	9/26/2008	19.775	9/26/20
	2,600,000	1,400,000	4/14/2009	15.105	4/14/20
Vincent W. Mitz	192,203	7,797	9/28/2007	17.195	9/28/20
	61,333	18,667	9/26/2008	19.775	9/26/20
	85,000	65,000	9/25/2009	16.43	9/25/20
	93,333	106,667	3/4/2010	17.32	3/4/20

		Working capital	3,908	2,985	7,926	18,194
Total assets	4,359		3,562	11,866	23,922	13,969
Capital lease obligation—current and non-current	20		-	-	86	49
Equipment loan—current and non-current	-		-	-	716	836
Deferred revenue—current and	-		-	9,167	7,517	4,167

Named Executive Officer	Number of Securities Underlying Unexercised Options (#) Exercisable	Number of Securities Underlying Unexercised Options (#) Unexercisable	Option Grant Date (1)	Option Exercise Price ($)	Option Expiration Date
non-current					
Convertible notes payable	-	-	-	-	-
Convertible preferred stock	164	175	192	-	-
Common stock and additional paid-in capital	9,127	10,869	14,683	32,797	33,933
Total stockholders' equity	4,093	3,252	1,813	14,320	7,345

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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 a clinical stage biopharmaceutical company focused on developing 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.

In August 2006, we entered into a collaboration and license agreement with 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. 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.

Alcon is responsible for all of the costs that it incurs in developing the products using the Aganocide compounds. We announced the clearance of an Investigational New Drug (IND) application submitted by Alcon to the FDA to permit the clinical development of Novabay's NVC-422 for infection of the eye. The IND clearance has triggered the immediate payment of the first milestone of $1,000,000 from Alcon to Novabay. 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. The agreement is exclusive and worldwide in scope, with the exception of Asian markets. Galderma will be responsible for the development costs of the acne and other indications, except in Japan, where they will be shared, 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 exclusive rights to promote the products developed under the agreement in the hospital and other healthcare institutions in North America. Galderma will pay to Novabay certain upfront fees, ongoing fees, reimbursements, and milestone payments related to achieving development and commercialization of its Aganocide© compounds. If products are commercialized under this agreement then NovaBay will receive royalties whose rates escalate as sales increase.

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. 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. We have not received 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 technology access fee from Alcon. 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, 2008, we had an accumulated deficit of $26.6 million. Our accumulated deficit resulted from research and development expenses and general and administrative expenses. We expect to continue 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.

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Recent Events

In March 2008, we amended the Financial Advisory and Investor Relations Consulting Agreement dated February 13, 2007 with PM Holdings Ltd. Under the terms of the original agreement, we 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 common shares at an exercise price of $4.00 per share. Under the amended agreement, no further cash or equity amounts are payable during the duration of the agreement through February 2010. We paid the upfront cash amount and issued the warrants during April 2008.

In May 2008, we completed our Phase I safety study of our lead Aganocide compound, NVC-422, as a lavage solution for catheterized patients. The study showed that NVC-422 was well tolerated in the bladder in the Phase I trial. This study was designed to evaluate the safety and tolerability of NVC-422 in the bladder, and upon completion of the Phase I, the lavage solution for catheterized patients showed no adverse events. This Phase I study supports the development of the product as a candidate to treat or prevent catheter associated urinary tract infections (CAUTI).

In May 2008, NovaBay completed its Phase IIa study of NVC-422 for nasal decolonization of Staphylococcus aureus, including MRSA (Methicillin Resistant Staphylococcus Aureus). In this study, two concentrations of a prototype nasal spray formulation of NVC-422 was tested to decolonize the lower nasal passages and were both found to be well tolerated. Based on a statistical analysis the higher dose treatment group provided consistent S. aureus reduction below the baseline score throughout the treatment period.

In July 2008, we received our second issued patent in the U.S. The patent provides coverage for a method of disinfecting open wounds and burns, promoting wound healing and providing ocular disinfection using a specific range of formulations of NVC-101. This patent was issued on July 1, 2008 and will expire in 2024

In July 2008, we completed a successful testing of our formulation of our lead Aganocide compound for dermatological uses, known as AgaDerm, in a challenging animal model of dermatophyte infection. The study showed that the AgaDerm formulation delivered an Aganocide compound effectively when applied on the surface of the skin and enhanced its penetration into hair follicles. The infectious agent was a dermatophyte, Trichophyton mentagrophytes, a parasitic fungus that causes infections of the nails, hair and skin, including ringworm. The Aganocide compound in the AgaDerm formulation was shown to be highly effective not only on the skin surface, but also showed potent ability to kill organisms invading the hair.

In November 2008, we commenced patient enrollment in a Phase II Exploratory Study of hospitalized patients who are catheterized and have bacteriuria. This Phase II study is to explore the feasibility of developing NVC-422 as a product candidate to treat or prevent catheter-associated urinary tract infections (CAUTI).

In December 2008, we notified the Toronto Stock Exchange (TSX) of our intent to voluntarily remove our listing of common stock from the TSX in order to consolidate trading on the NYSE Amex.

In December 2008, we received our third issued patent in the U.S. The patent 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.

On March 25, 2009, we announced that we have entered into an agreement with Galderma S.A. to develop and commercialize our novel proprietary Aganocide® compounds. The exclusive agreement is worldwide in scope, except in certain Asian markets, and covers acne and impetigo and potentially other major dermatological conditions, excluding onychomycosis (nail fungus) and orphan drug indications.

Critical Accounting Policies and Estimates

Our financial statements have been prepared in accordance with generally accepted accounting principles in the United States. The preparation of these financial statements requires us to make estimates and assumptions 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, income taxes, intangible assets, long-term service contracts 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.

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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 aid you in 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 Emerging Issues Task Force ("EITF") Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables", 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. We recognize revenue in accordance with SEC Staff Accounting Bulletin ("SAB") No. 101, "Revenue Recognition in Financial Statements", as amended by SAB No. 104 (together, SAB 104). In accordance with SAB 104, 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.

Assuming the elements meet the EITF No. 00-21 criteria for separation and the SAB 104 requirements for recognition, 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. 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 in accordance with EITF Issue No. 99-19, "Reporting Revenue Gross as a Principal versus Net as an Agent," 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. 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. 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.

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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 of foreign, in which the patent is being secured.

Stock-Based Compensation

On January 1, 2006, we adopted the fair value recognition provisions of Statement of Financial Accounting Standards (“SFAS”) No. 123R, “Share-Based Payment”. SFAS No. 123R replaced SFAS No. 123 and superseded Accounting Principles Board (“APB”) Opinion No. 25, “Accounting for Stock Issued to Employees” and related interpretations. Under the fair value recognition provisions of SFAS No. 123R, 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. We were required to utilize the prospective application method prescribed by SFAS No. 123R, under which prior periods are not revised for comparative purposes. Under SFAS No. 123R, 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. Under the prospective application transition method, non-public entities that previously used the minimum value method of SFAS No. 123 should continue to account for non-vested equity awards outstanding at the date of adoption of SFAS No. 123R in the same manner as they had been accounted for prior to adoption. SFAS No. 123R specifically prohibits pro forma disclosures for those awards valued using the minimum value method. The valuation and recognition provisions of SFAS No. 123R apply to new awards and to awards outstanding as of the adoption date that are subsequently modified. The adoption of SFAS No. 123R had a material effect on our 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 SFAS No. 123R, we valued our stock-based awards using the minimum value method and provided pro-forma information regarding stock-based compensation and net income required by SFAS No. 123. We did not recognize stock-based compensation expense in our statements of operations for option grants to our employees or directors for the periods prior to our adoption of SFAS No. 123R 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.

We account for stock compensation arrangements with non-employees in accordance with SFAS No. 123R and EITF Issue No. 96-18, “Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services”, 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.

The adoption of SFAS No.123R had a material effect on our financial position and results of operations. See Note 10 of the Notes to Consolidated Financial Statements, included in Part II, Item 8 of this report, for further information regarding stock-based compensation expense and the assumptions used in estimating that expense.

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.

Recent Accounting Pronouncements

In March 2008, the FASB issued SFAS No. 161, “Disclosures about Derivative Instruments and Hedging Activities”. SFAS No. 161 changes the disclosure requirements for derivative instruments and hedging activities by requiring enhanced disclosures about how and why an entity uses derivative instruments, how derivative instruments and related hedged items are accounted for under SFAS No. 133, “Accounting for Derivative Instruments and Hedging Activities,” and how derivative instruments and related hedged items affect an entity’s operating results, financial position, and cash flows.

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SFAS No. 161 is effective for fiscal years beginning after November 15, 2008. Early adoption is permitted. We are currently reviewing the provisions of SFAS No. 161 and have not yet adopted the statement. However, as the provisions of SFAS No. 161 are only related to disclosure of derivative and hedging activities, we do not believe the adoption of SFAS No. 161 will have a material impact on our consolidated operating results, financial position, or cash flows.

In April 2008, the FASB issued FSP FAS 142-3, Determination of the Useful Life of Intangible Assets or FSP FAS 142-3. FSP FAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, Goodwill and Other Intangible Assets. The intent of the position is to improve the consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the intangible asset. FSP FAS 142-3 is effective for fiscal years beginning after December 15, 2008. We are assessing the potential impact that the adoption of FSP FAS 142-3 may have on our consolidated financial position, results of operations or cash flows.

In May 2008, the FASB issued SFAS No. 162, The Hierarchy of Generally Accepted Accounting Principles or SFAS No. 162. SFAS No. 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with GAAP. This statement shall be effective 60 days following the Securities and Exchange Commission’s approval of the Public Company Accounting Oversight Board amendments to AU Section 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles. We do not believe that implementation of this standard will have a material impact on our consolidated financial position, results of operations or cash flows.

In June 2008, the FASB issued FSP No. EITF 03-6-1, “Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities,” (FSP EITF 03-6-1). FSP EITF 03-6-1 states that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per share pursuant to the two-class method. FSP EITF 03-6-1 is effective for fiscal years beginning after December 15, 2008. Management has determined that the adoption of FSP EITF 03-6-1 will not have an impact on the Financial Statements.

Results of Operations

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

License and Collaboration Revenue

Total license and collaboration revenue was $5.9 million for the year ended December 31, 2007, compared to $6.7 million for the year ended December 31, 2008. License and collaboration revenue consisted almost exclusively of amounts earned under the license and collaboration agreement with Alcon for amortization of the upfront technology access fees and amounts that have been or will be reimbursed for the funding of research and development activities performed during the period. 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. The upfront technology access fee from KCI of $200,000 has been amortized on a straight-line basis over 18 months through December 2008.

To the extent we earn milestone payments under the Alcon and Galderma collaborations, we would expect revenues to increase. We expect to receive approximately $4 million under the Galderma agreement, and received the initial portion in March 2009. However, we cannot predict if and when we will receive any milestone payments from these collaborations.

Research and Development

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, 2008. 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. 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. 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 ongoing research and development expenses in 2009 and in subsequent years as we continue to increase our focus on developing product candidates, both independently and in collaboration with Alcon. In particular, we expect to incur ongoing clinical, chemistry, and manufacturing expenses during 2009 in connection with the common cold, dermatology, and catheter associated urinary tract infections programs.

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General and Administrative

General and administrative expenses increased by 29% to $5.6 million for the year ended December 31, 2008 from $4.4 million for the year ended December 31, 2007. This increase 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 2009 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 operate as a public company.

Other Income, Net

Other income, net decreased to $397,000 for the year ended December 31, 2008 from $487,000 for the year ended December 31, 2007. This decrease 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 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. Interest income relates primarily to interest earned on cash, cash equivalents and investments in marketable securities. See “Note 3-Short Term Investments.”

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.

Comparison of Years Ended December 31, 2006 and December 31, 2007

License and Collaboration Revenue

Total license and collaboration revenue was $1.5 million for the year ended December 31, 2006, compared to $5.9 million for the year ended December 31, 2007. License and collaboration revenue consisted primarily of amounts earned under the license and collaboration agreements with Alcon for amortization of the upfront technology access fees and amounts that have been or will be reimbursed for the funding of research and development activities performed during the period. The increase in revenue during 2007 as compared to 2006 is attributable to the timing of the Alcon and KCI agreements, which were entered into in August 2006 and June 2007, respectively. 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. The upfront technology access fee from KCI of $200,000 has been amortized on a straight-line basis over 18 months through December 2008.

Research and Development

Research and development expenses increased by 82% to $7.4 million for the year ended December 31, 2007 from $4.1 million for the year ended December 31, 2006. This increase was due in part to an increase in salary and benefits expense of $1.5 million, as the average number of research and development personnel increased by 77% from 2006 to 2007, and included the hiring of several senior personnel. In connection with this increase in hiring, recruiting and relocation costs increased by $110,000 due to an increased reliance on outside personnel recruitment firms and the funding of relocation benefits. Also, during the last three quarters of 2007, we conducted Phase I and Phase II clinical studies for the pre-surgical nasal preparation indication, which caused our clinical expenses for the year ended December 31, 2007 to increase by $730,000 over the year ended December 31, 2006. Additionally, increased efforts around the chemistry, manufacturing and controls related to NVC-422 resulted in an increase of $538,000 from the year ended December 31, 2006 to the year ended December 31, 2007 as we produced more drug substance to support our internal research programs and Alcon collaboration requirements. Costs for outside consultants increased by $245,000 during the year ended December 31, 2007 as a result of increased regulatory activity associated with the IND filings for the pre-surgical nasal preparation and catheter associated urinary tract infection indications and the filing of the 510(k) application related to our NVC-101 compound, as well as due to increased usage of manufacturing and formulation consultants in connection with the KCI agreement. The amortization of stock-based compensation increased by $121,000 from 2006 to 2007 as a result of an increased number of grants becoming subject to the SFAS No. 123R guidance.

General and Administrative

General and administrative expenses increased by 47% to $4.4 million for the year ended December 31, 2007 from $3.0 million for the year ended December 31, 2006. This increase was due in part to an increase in salary and benefits expense of $494,000 as the average number of general and administrative personnel grew by 27% from 2006 to 2007. The increase in general and administrative expenses during the year ended December 31, 2007 was also attributable to the issuance of $360,000 in cash and stock to a consultant for investor relations and financial advisory services and cash and stock payments of $114,000 made to our non-employee directors upon the closing of the IPO and for ongoing director compensation. Rent expense increased by $209,000 during the year ended December 31, 2007 compared to the same period in the prior year because we leased additional space in late 2006 and during the second and fourth quarters of 2007 to accommodate our increased personnel and expanded laboratory facilities. Accounting expenses increased by $97,000 from the 2006 to the 2007 period as audit and tax activities increased in preparation for becoming a public company.

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Other Income, Net

Other income, net increased to $488,000 for the year ended December 31, 2007 from $240,000 for the year ended December 31, 2006. This increase was primarily attributable to increased interest income earned due to higher average cash balances as a result of the $10.0 million upfront cash amount received from Alcon in August 2006 and the $17.1 million received upon the closing of the IPO in October 2007.

Liquidity and Capital Resources

We have incurred cumulative net losses of $26.6 million since inception through December 31, 2008. 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 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, 2008, we have not achieved any milestone nor has any product 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 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, 2008, we had an outstanding equipment loan balance of $716,000 carrying a weighted-average interest rate of 10.57%. The principal and interest due under the loan will be repaid in equal monthly installments through April 2011. As of December 31, 2008 there was $206,000 available for borrowing under this equipment loan facility.

In March 2009, we entered into a license agreement with Galderma. Under the terms of the agreement, we have received an initial upfront payment. In addition, Galderma will pay to Novabay certain upfront fees, ongoing fees, reimbursements, and milestone payments related to achieving development and commercialization of its Aganocide® compounds.

Cash and Cash Equivalents

As of December 31, 2008, we had cash, cash equivalents, and short-term investments of $12.1 million compared to $22.4 million at December 31, 2007, and $11.1 million at December 31, 2006.

Cash Provided by (Used in) Operating Activities

For the years ended December 31, 2008 and 2007, cash used in operating activities of $9.9 million $6.3 million, respectively, 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.

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For the year ended December 31, 2006, cash provided by operating activities of $4.7 million was attributable primarily to an increase in deferred revenue related to the $10.0 million upfront technology access fee received from Alcon and an increase in accounts payable and accrued liabilities reflecting amounts that were expensed during the period but not paid until after December 31, 2006. This amount was offset by our net loss of $5.3 million, excluding the amounts recognized for stock-based compensation and depreciation, which are non-cash expenses.

Cash Used in Investing Activities

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.

For the year ended December 31, 2006, cash used in investing activities of $5.5 million was attributable to purchases of short-term investments (net of maturities or sales) of $5.2 million and purchases of property and equipment of $362,000.

Cash Provided by Financing Activities

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.

Net cash provided by financing activities of $3.5 million for the year ended December 31, 2006 was attributable to sales of preferred stock of $2.6 million and proceeds from option and warrant exercises of $1.0 million, partially offset by $93,000 of costs incurred in preparation for our initial public offering.

Quarterly Results of Operations

The following table presents unaudited quarterly results of operations for the eight quarters ended December 31, 2008. 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 (1)							
	March 31, 2007	June 30, 2007	Sept. 30, 2007	Dec. 31, 2007	March 31, 2008	June 30, 2008	Sept. 30, 2008	Dec. 31, 2008
	(in thousands, except per share data)							
Statements of Operations Data:								
Revenue	$ 1,483	$ 1,465	$ 1,444	$ 1,521	$ 1,492	$ 1,442	$ 1,592	$ 2,196
Operating expenses:								

Research and development	1,463	2,066	2,051	1,841	2,647	2,173	1,443	2,541
General and administrative	1,035	1,069	1,021	1,243	1,684	1,773	1,715	1,255
Total operating expenses	2,498	3,135	3,072	3,084	4,331	3,946	3,158	3,796
Other income (expense), net	122	113	72	181	163	94	77	64
Net loss before income taxes	(893)	(1,557)	(1,556)	(1,382)	(2,676)	(2,410)	(1,489)	(1,536)
Provision for income taxes	-	-	-	(12)	(2)	-	-	-
Net loss	$ (893)	$ (1,557)	$ (1,556)	$ (1,394)	$ (2,678)	$ (2,410)	$ (1,489)	$ (1,536)
Net loss per share:								
Basic and diluted	$ (0.14)	$ (0.24)	$ (0.24)	$ (0.09)	$ (0.13)	$ (0.11)	$ (0.07)	$ (0.07)
Shares used in per share calculations:								
Basic and diluted	6,416	6,500	6,564	16,332	21,288	21,334	21,443	21,469

(1) The 2008 and 2007 amounts were computed independently for each quarter, and the sum of the quarters may not total the annual amounts.

Net Operating Losses and Tax Credit Carryforwards

As of December 31, 2008 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 2014 and 2028.

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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, 2008 were as follows:

Contractual Obligations	Total	Less than 1 Year	1 - 3 Years (in thousands)	3 - 5 Years	More Than 5 years
Operating leases	$ 6,594	$ 860	$ 2,787	$ 2,947	$ -
Capital lease	52	45	7	-	-
Equipment loan	945	440	505	-	-
	$ 7,591	$ 1,344	$ 3,300	$ 2,947	$ -

Our commitments under the operating leases shown above consist of payments relating to five leases for laboratory and office space in one office building in Emeryville, California. These leases expire on various dates through 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 $12,581 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 $108,690 of interest payments over the remaining term of the loan.

We believe our cash balance at December 31, 2008 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.

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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. 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

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and the Stockholders of
NovaBay Pharmaceuticals, Inc.

We have audited the accompanying consolidated balance sheets of NovaBay Pharmaceuticals, Inc. (a development stage company) as at December 31, 2007 and 2008 and the related consolidated statements of operations, cash flows and stockholders' equity for the years ended December 31, 2006, 2007 and 2008 and for the period from July 1, 2002 (date of development stage inception) to December 31, 2008. These 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. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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, 2007 and 2008 and the results of its operations and its cash flows for the years ended December 31, 2006, 2007 and 2008 and for the period from July 1, 2002 (date of development stage inception) to December 31, 2008 in conformity with generally accepted accounting principles in the United States of America.

/s/ Davidson & Company LLP
Chartered Accountants

Vancouver, Canada
March 24, 2009

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

	December 31, 2007	December 31, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	$ 10,941	$ 12,099
Short-term investments (Note 3)	11,412	-
Prepaid expenses and other current assets	419	414
Total current assets	22,772	12,513
Property and equipment, net (Note 4)	1,150	1,456
TOTAL ASSETS	$ 23,922	$ 13,969
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Current liabilities:		
Accounts payable	$ 142	$ 406
Accrued liabilities (Note 5)	1,141	1,166
Capital lease obligation (Note 6)	37	42
Equipment loan (Note 7)	219	366
Deferred revenue	3,039	2,500
Total current liabilities	4,578	4,480
Capital lease obligation - non-current (Note 6)	49	7
Equipment loan - non-current (Note 7)	497	470
Deferred revenue - non-current	4,478	1,667
Total liabilities	9,602	6,624
Stockholders' Equity:		
Common stock, $0.01 par value; 65,000 and 65,000 shares authorized at December 31, 2007 and December 31, 2008, respectively, 21,269 and 21,471 shares issued and outstanding at December 31, 2007 and December 31, 2008, respectively.	212	215
Additional paid-in capital	32,585	33,718
Accumulated other comprehensive income (loss)	(3)	-
Accumulated deficit during development stage	(18,474)	(26,588)
Total stockholders' equity	14,320	7,345
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 23,922	$ 13,969

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, 2006	2007	2008	Cumulative Period from July 1, 2002 (date of development stage inception) to December 31, 2008
REVENUE				
License and collaboration revenue	$ 1,533	$ 5,913	$ 6,722	$ 14,168
Total revenue	1,533	5,913	6,722	14,168
EXPENSES				
Operating Expenses:				
Research and development	4,087	7,421	9,595	25,007
General and administrative	2,972	4,368	5,636	16,964
Total operating expenses	7,059	11,789	15,231	41,971
Other income, net	240	488	397	1,229
Net loss before income taxes	(5,286)	(5,388)	(8,112)	(26,574)
Provision for income taxes	-	(12)	(2)	(14)
Net loss	$ (5,286)	$ (5,400)	$ (8,114)	$ (26,588)
Net loss per share:				
Basic and diluted	$ (0.92)	$ (0.60)	$ (0.38)	
Shares used in per share calculations:				
Basic and diluted	5,715	8,974	21,312	

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 STOCKHOLDERS' EQUITY
(in thousands)

	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Accumulated Other Comprehensive 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	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	3,902	39	487	-	(544)	9
Comprehensive loss:						
Net loss	-	-	-	-	(977)	(977)
Total comprehensive loss						(977)
Issuance of Series A preferred stock	-	-	192	-	-	197
Issuance of Series B preferred stock net of issuance costs of $86	-	-	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
Balance at December 31, 2003	4,104	41	2,217	-	(1,521)	802
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	-	-	1,112	-	-	1,139
	-	-	420	-	-	429

Issuance of Series B preferred stock upon conversion of notes						
Issuance of Series C preferred stock net of issuance costs of $123	-	-	5,178	-	-	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	4,523	45	9,082	-	(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	-	-	158	-	-	162
Issuance of Series D preferred stock net of issuance costs of $36	-	-	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
Balance at December 31, 2005	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)
Issuance of Series D preferred stock net of issuance costs of $114	-	-	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	6,311	63	14,620	12	(13,074)	1,813

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

	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit During Development Stage	Total Stockholders' Equity
Balance at December 31, 2005	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)
Issuance of Series D preferred stock net of issuance costs of $114	-	-	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	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	9,614	96	96	-	-	-
Issuance of stock and warrants in connection with IPO, net of offering costs	5,000	50	17,120	-	-	17,170
	298	3	111	-	-	114

Issuance of stock for option exercises						
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 (losses)				35		35
Change in unrealized gains (losses) on investments	-	-	-	(32)	-	(32)
Total comprehensive loss						(8,111)
Conversion of preferred stock to common stock in connection with IPO	-	-	-	-	-	-
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

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 CASH FLOWS
(in thousands)

	Year Ended December 31, 2006	2007	2008	Cumulative Period from July 1, 2002 (date of development stage inception) to December 31, 200
Cash flows from operating activities:				
Net loss	$ (5,286)	$ (5,400)	$ (8,114)	$ (26,588)
Adjustments to reconcile net loss to net cash used in operating activities:				
Depreciation and amortization	74	183	304	704
Accretion of discount on short-term investments	(32)	(246)	(23)	(301)
Net realized (gain) loss on sales of short-term investments	20	-	(35)	(3)
Loss on disposal of property and equipment	1	-	-	121
Stock-based compensation expense for options issued to employees and directors	313	428	721	1,462
Compensation expense for warrants & stock issued for services	-	-	100	100
Stock-based compensation expense for options and stock issued to non-employees	54	210	162	525
Taxes paid by LLC	-	-		1
Changes in operating assets and liabilities:				
Decrease (increase) in prepaid expenses and other assets	(143)	(193)	5	(409)
Increase in accounts payable and accrued liabilities	576	397	289	1,597
Increase (decrease) in deferred revenue	9,167	(1,650)	(3,351)	4,166
Net cash provided by (used in) operating activities	4,744	(6,271)	(9,942)	(18,625)
Cash flows from investing activities:				
Purchases of property and equipment	(362)	(663)	(610)	(2,160)
Proceeds from disposal of property and equipment	1	1	-	44
Purchases of short-term investments	(11,293)	(49,197)	(32,097)	(94,544)
Proceeds from maturities and sales of short-term investments	6,141	44,199	43,571	94,847
Cash acquired in purchase of LLC	-	-	-	516
Net cash provided by (used in) investing activities	(5,513)	(5,660)	10,864	(1,297)
Cash flows from financing activities:				
Proceeds from preferred stock issuances	2,558	-	-	11,160

Proceeds from common stock issuances	-	-	-	17
Proceeds from exercise of options and warrants	999	114	153	1,761
Proceeds from initial public offering, net of costs	(93)	17,170	-	17,077
Proceeds from stock subscription receivable	-	-	-	873
Proceeds from issuance of notes	-	-	-	405
Payments on capital lease	-	(31)	(37)	(108)
Proceeds from borrowings under equipment loan	-	794	422	1,216
Payments on equipment loan	-	(78)	(302)	(380)
Tax benefit from stock plans	-	-	-	-
Net cash provided by financing activities	3,464	17,969	236	32,021
Net increase in cash and cash equivalents	2,695	6,038	1,158	12,099
Cash and cash equivalents, beginning of period	2,208	4,903	10,941	-
Cash and cash equivalents, end of period	$ 4,903	$ 10,941	$ 12,099	$ 12,099

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 CASH FLOWS
(in thousands)

	Year Ended December 31, 2006	2007	2008	Cumulative Period from July 1, 2002 (date of development stage inception) to December 31, 2008
Supplemental disclosure of cash flow information:				
Interest paid	$ 2	$ 34	$ 102	$ 146
Income taxes paid	$ -	$ -	$ -	$ -
Non-cash activities:				
Issuance of stock, options and warrants for stock offering costs	$ 64	$ 524	$ -	$ 801
Property and equipment acquired under capital lease obligation	$ -	$ 117	$ 62	$ 219

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NOVABAY PHARMACEUTICALS, INC.
(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. ORGANIZATION

NovaBay Pharmaceuticals, Inc. (the "Company") is a clinical stage biopharmaceutical company focused on developing 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.

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. 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 are exercisable on or after October 31, 2008 and expire on October 31, 2010.

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 of Statement of Financial Accounting Standard ("SFAS") No. 7, "Accounting and Reporting by Development Stage Enterprises". 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, 2008, we 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.

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, 2008, 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-

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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. Premiums and discounts are amortized or accreted over the life of the related security as an adjustment to yield using the straight-line method. The amortization and accretion, 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

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.

Fair Value of Financial Assets and Liabilities

Financial instruments, including cash and cash equivalents, 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 its 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 the guidance of Statement of Financial Accounting Standards No. 157, Fair Value Measurements (“Statement No. 157”) 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 of Statement No. 157 for financial assets and liabilities, as well as for any other assets and liabilities that are carried at fair value on a recurring basis. The adoption of the provisions of Statement No. 157 did not materially impact the Company’s consolidated financial position and results of operations.

Statement No. 157 defines fair value 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. Statement No. 157 also establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. Statement No. 157 describes 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, 2008 there were no assets or liabilities subject to additional disclosure under Statement No. 157.

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

We account for long-lived assets in accordance with SFAS No. 144, “Accounting for the Impairment or Disposal of Long-Lived Assets and for Long-Lived Assets to be Disposed of”, 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, we would recognize the amount of the impairment based on the 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.

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NOVABAY PHARMACEUTICALS, INC.
(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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 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 Emerging Issues Task Force ("EITF") Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables", 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. We recognize revenue in accordance with SEC Staff Accounting Bulletin ("SAB") No. 101, "Revenue Recognition in Financial Statements", as amended by SAB No. 104 (together, "SAB 104"). In accordance with SAB 104, 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.

Assuming the elements meet the EITF No. 00-21 criteria for separation and the SAB 104 requirements for recognition, 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 in accordance with EITF Issue No. 99-19, "Reporting Revenue Gross as a Principal versus Net as an Agent," 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.

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NOVABAY PHARMACEUTICALS, INC.
(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Stock-Based Compensation

On January 1, 2006, we adopted the fair value recognition provisions of SFAS No. 123R, "Share-Based Payment". SFAS No. 123R replaced SFAS No. 123 and superseded Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees" and related interpretations. Under the fair value recognition provisions of SFAS No. 123R, 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. We were required to utilize the prospective application method prescribed by SFAS No. 123R, 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 SFAS No. 123 should continue to account for non-vested equity awards outstanding at the date of adoption of SFAS No. 123R in the same manner as they had been accounted for prior to adoption. SFAS No. 123R specifically prohibits pro forma disclosures for those awards valued using the minimum value method. The valuation and recognition provisions of SFAS No. 123R apply to new awards and to awards outstanding as of the adoption date that are subsequently modified. The adoption of SFAS No.123R had a material effect on our 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 SFAS No. 123R, we valued our stock-based awards using the minimum value method and provided pro-forma information regarding stock-based compensation and net income required by SFAS No. 123. We did not recognize stock-based compensation expense in our statements of operations for option grants to our employees or directors for the periods prior to our adoption of SFAS No. 123R 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.

We account for stock compensation arrangements with non-employees in accordance with SFAS No. 123R and EITF Issue No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services", 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.

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

We compute net income (loss) per share in accordance with SFAS No. 128, “Earnings per Share” which requires presentation of 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 as their effect would be anti-dilutive. There is no difference between basic and diluted net loss per share for all periods presented due to the Company’s net losses.

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)	2006	2007	2008
Convertible preferred stock	9,614	-	-
Stock options	2,401	2,896	3,371
Stock warrants	-	350	650

NOVABAY PHARMACEUTICALS, INC.
(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Recent Accounting Pronouncements

In December 2007, the Emerging Issues Task Force (EITF") met and ratified EITF No.07-01, Accounting for

Collaborative Arrangements, in order to define collaborative arrangements and to establish reporting requirements for transactions between participants in a collaborative arrangement and between participants in the arrangement and third parties. This EITF is effective for financial statements issued for fiscal years beginning after December15, 2008, and interim periods within those fiscal years. This EITF is to be applied retrospectively to all prior periods presented for all collaborative arrangements existing as of the effective date. We are currently assessing the impact of this EITF to our consolidated financial statements.

In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities". SFAS No. 161 changes the disclosure requirements for derivative instruments and hedging activities by requiring enhanced disclosures about how and why an entity uses derivative instruments, how derivative instruments and related hedged items are accounted for under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," and how derivative instruments and related hedged items affect an entity's operating results, financial position, and cash flows.

SFAS No. 161 is effective for fiscal years beginning after November 15, 2008. Early adoption is permitted. We are currently reviewing the provisions of SFAS No. 161 and have not yet adopted the statement. However, as the provisions of SFAS No. 161 are only related to disclosure of derivative and hedging activities, we do not believe the adoption of SFAS No. 161 will have a material impact on our consolidated operating results, financial position, or cash flows.

In April 2008, the FASB issued FSP FAS 142-3, Determination of the Useful Life of Intangible Assets or FSP FAS 142-3. FSP FAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, Goodwill and Other Intangible Assets. The intent of the position is to improve the consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the intangible asset. FSP FAS 142-3 is effective for fiscal years beginning after December 15, 2008. We are assessing the potential impact that the adoption of FSP FAS 142-3 may have on our consolidated financial position, results of operations or cash flows.

In May 2008, the FASB issued SFAS No. 162, The Hierarchy of Generally Accepted Accounting Principles or SFAS No. 162. SFAS No. 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with GAAP. This statement shall be effective 60 days following the Securities and Exchange Commission's approval of the Public Company Accounting Oversight Board amendments to AU Section 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles. We do not believe that implementation of this standard will have a material impact on our consolidated financial position, results of operations or cash flows.

In June 2008, the FASB issued FSP No. EITF 03-6-1, "Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities," (FSP EITF 03-6-1). FSP EITF 03-6-1 states that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per share pursuant to the two-class method. FSP EITF 03-6-1 is effective for fiscal years beginning after December 15, 2008. Management has determined that the adoption of FSP EITF 03-6-1 will not have an impact on the Financial Statements.

NOTE 3. SHORT-TERM INVESTMENTS

Short-term investments at December 31, 2007 and 2008 consisted of the following:

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NOVABAY PHARMACEUTICALS, INC.
(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

	December 31, 2007			
(in thousands)	Amortized Cost	Gross Unrealized/Realized Gains	Gross Unrealized/Realized Losses	Market Value
Corporate bonds	$ 5,362	$ -	$ (4)	$ 5,358
U.S. Agencies	5,553	1	-	5,554
Municipal Bonds	500	-	-	500
Certificates of Deposit	-	-	-	-
Other Fixed Income	-	-	-	-
	$ 11,415	$ 1	$ (4)	$ 11,412

	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	-	-	-	-
	$ -	$ -	$ -	$ -

Contractual maturities of short-term investments as of December 31, 2007 and 2008 were as follows:

	December 31, 2007	
(in thousands)	Amortized Cost	Market Value
Due in one year or less	$ 9,915	$ 9,912
Due after 10 years	1,500	1,500
Total	$ 11,415	$ 11,412

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

During the years ended December 31, 2006, 2007, and 2008 we recognized a net realized gain/ (loss) of $(20,000), $0 and $35,000 respectively. For the cumulative period from July 1, 2002 (date of development stage inception) to December 31, 2008, we recognized a net realized gain of $3,000. Short-term investments were liquidated in the fourth quarter, resulting in no amounts to report.

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NOVABAY PHARMACEUTICALS, INC.
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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, 2007	December 31, 2008
Office and laboratory equipment	$ 1,243	$ 1,728
Furniture and fixtures	96	113
Software	72	110
Leasehold improvement	73	143
Total property and equipment, at cost	1,484	2,094
Less: accumulated depreciation	(334)	(638)
Total property and equipment, net	$ 1,150	$ 1,456

Depreciation expense was $74,000, $183,000 and $304,000 for the years ended December 31, 2006, 2007 and 2008, respectively and $704,000 for the cumulative period from July 1, 2002 (date of development stage inception) to December 31, 2008.

NOTE 5. ACCRUED LIABILITIES

Accrued liabilities consisted of the following:

(in thousands)	December 31, 2007	December 31, 2008
Research and development	$ 178	$ 509
Employee payroll and benefits	688	423
Professional fees	197	182
Other	78	52
Total accrued liabilities	$ 1,141	$ 1,166

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, 2007	December 31, 2008
Office and laboratory equipment	$ 166	$ 229
Less: accumulated depreciation	(19)	(47)
Capital lease assets, net	$ 147	$ 182

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Future minimum lease payments under capital leases were as follows at December 31, 2008:

(in thousands)	Lease Commitment	
Year ending December 31,		
2009	$	45
2010		7
2011		-
2012		-
2013		-
Total minimum lease payments		52
Less: amount representing interest		(3)
Present value of minimum lease payments	$	49

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.

As of December 31, 2008, we had an outstanding equipment loan balance of $836,291 carrying a weighted-average interest rate of 10.95%. At December 31, 2008, there was $216,253 available for borrowing under this equipment loan facility.

Future minimum loan payments under equipment loans were as follows at December 31, 2008:

(in thousands)	Loan Commitment	
Year ending December 31:		
2009	$	440
2010		396
2011		109
2012		-
2013		-
Total minimum loan payments	$	945
Less: amount representing interest		(109)
Present value of minimum loan payments	$	836

NOTE 8. COMMITMENTS AND CONTINGENCIES

Operating Leases

We lease laboratory facilities and office space under operating leases which expire at various dates through 2015. Rent expense was \$317,000, \$526,000, and \$620,532 for the years ended December 31, 2006, 2007 and 2008, respectively, and \$1,941,532 for the cumulative period from July 1, 2002 (date of development stage inception) to December 31, 2008.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The future minimum lease payments under non-cancellable operating leases were as follows as of December 31, 2008:

(in thousands)	Lease Commitment
Year ending December 31:	
2009	$ 860
2010	893
2011	929
2012	965
2013	1,004
2014	1,044
2015	899
Total lease commitment	$ 6,594

Legal Matters

From time to time, we may be involved in various legal proceedings arising in the ordinary course of business. There are no matters at December 31, 2008 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, we issued 3.2 million shares of Series A Convertible Preferred Stock for net proceeds of $647,000. In 2003 and 2004, we issued 6.9 million shares of Series B Convertible Preferred Stock for net proceeds of $3.0 million. In 2004 and 2005, we issued 6.7 million shares of Series C Convertible Preferred Stock for net proceeds of $5.4 million. In 2005 and 2006, we 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 our IPO in October 2007. In connection with the IPO, we amended our 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, 2008, there were no shares of preferred stock outstanding.

Common Stock

Under our amended articles of incorporation, we are 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, 2008. In August 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. In October 2007, we completed an initial public offering of our common stock 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.

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. The significant terms of the Series A, Series B, Note, and Underwriter 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. The 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. The 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. The warrants expired on June 30, 2006.

Underwriter Warrants—In connection with the IPO, we 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 are 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. We 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, we 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, we agreed to pay PM Holdings $28,000 per month through February 2010 for financial and investor relations advisory services. The amendment to this agreement eliminates the monthly cash payment obligation and instead provides 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.

At December 31, 2008, there were outstanding warrants to purchase 650,000 shares of common stock at a weighted-average exercise price of $4.00 per share. None of the warrants were exercisable at December 31, 2008.

NOTE 10. EQUITY-BASED COMPENSATION

Equity Compensation Plans

Prior to the IPO, we 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, we 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. As of December 31, 2008, there were 741,502 shares available for future grants 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 our 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. We issue new shares to satisfy option exercises under the plans.

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Stock Option Summary

The following table summarizes information about our stock options outstanding at December 31, 2008 and activity during the year 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	$ 3.31		
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	6.8	$ 767
Vested and expected to vest at December 31, 2008	3,217	$ 1.66	6.7	$ 767
Vested at December 31, 2008	2,112	$ 1.15	5.4	$ 763
Exercisable at December 31, 2008	2,470	$ 1.41	5.8	$ 767

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 our common stock as quoted on the American Stock Exchange as of December 31, 2008. We received cash payments for the exercise of stock options in the amount of $23,000, $114,000 and $149,000 during the years ended December 31, 2006, 2007 and 2008, respectively. The aggregate intrinsic value of stock option awards exercised was $126,000, $571,000 and $108,000 for the years ended December 31, 2006, 2007 and 2008, respectively, as determined at the date of option exercise.

The options outstanding and vested by exercise price at December 31, 2008 were as follows (number of options in thousands):

	Options Outstanding			Options Vested	
Range of Exercise Prices	Number Outstanding	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life (Years)	Number Vested	Weighted-Average Exercise Price
$0.20	544	$ 0.20	3.2	544	$ 0.20
$0.30	318	$ 0.30	5.0	318	$ 0.30
$0.56	192	$ 0.56	5.4	184	$ 0.56

$0.94 - $1.20	253	$	1.15	4.2	229	$	1.14
$1.70 - $1.97	1,157	$	1.82	8.4	548	$	1.70
$2.00 - $2.48	217	$	2.21	8.2	96	$	2.21
$3.56 - $4.00	690	$	3.71	8.7	193	$	3.73
	3,371	$	1.71	6.8	2,112	$	1.15

Stock Option Awards to Employees and Directors

We grant options to purchase common stock to some of our employees and directors at prices equal to or greater than the market value of the stock on the dates the options are granted. We have 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

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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 we applied to value our stock-based awards.

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	2006	2007	2008
Expected price volatility	74.0%	68.9%	70.3%
Expected term (in years)	5.7	6	6.1
Risk-free interest rate	4.8%	4.1%	3.1%
Dividend yield	0.0%	0.0%	0.0%
Weighted-average fair value of options granted during the period	$ 1.06	$ 2.17	$ 1.56

Expected Price Volatility—This is a measure of the amount by which the stock price has fluctuated or is expected to fluctuate. Prior to the adoption of SFAS No. 123R, we assumed 0% price volatility in accordance with the minimum value method requirements of SFAS No. 123. Under SFAS No. 123R, which we adopted on January 1, 2006, 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.

Forfeiture Rate—Under SFAS No. 123R, 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, 2006 and 2007, 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, 2006, 2007 and 2008, we recognized stock-based compensation expense of $313,000 $399,000 and $721,000, respectively, for option awards to employees and directors. As of December 31, 2008, total unrecognized compensation cost related to unvested stock options granted or modified on or after January

1, 2006 was $1.7 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, we 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 unrestricted common stock for each board and committee meeting attended, up to specified annual maximums. In accordance with these provisions, we issued 50,971 shares of common stock to independent directors during the year ended December 31, 2008. 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 $123,735 for

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common stock awards to directors during the year ended December 31, 2008.

Summary of Stock-Based Compensation Expense Under SFAS No. 123R

Upon the adoption of SFAS No. 123R on January 1, 2006, we began recognizing stock-based compensation expense in the statements of operations for all employee and director equity awards granted or modified on or after the adoption date. Stock-based compensation expense is classified in the statements of operations in the same expense line items as cash compensation. Since we continue to operate at a net loss, we do not expect to realize any current tax benefits related to stock options.

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)	2006	2007	2008
Research and Development	227	206	412
General and Administrative	86	222	432
Total stock-based compensation expense	$ 313	$ 428	$ 844

Stock-Based Awards to Non-Employees

During the years ended December 31, 2006, 2007 and 2008, we granted options to purchase an aggregate of 58,000, 69,000 and 16,000 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	2006	2007	2008
Expected price volatility	74.0%	71.0%	70.0%
Expected term (in years)	5.3	5.3	6.1
Risk-free interest rate	4.4%	4.7%	3.1%
Dividend yield	0.0%	0.0%	0.0%
Weighted-average fair value of options granted during the period	$ 0.78	$ 1.70	$ 1.26

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For the years ended December 31, 2006 and 2007, we recognized stock-based compensation expense of $49,000, and $118,000, respectively, related to non-employee option grants. For the year ended December 31, 2008 we 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,		
	2006	2007	2008
(in thousands)			
Amortization of Upfront Technology Access Fee	$ 800	$ 2,500	$ 2,500
On-going Research and Development	700	2,700	2,700
Materials, Equipment, and Contract Study Costs	-	700	1,500
	$ 1,500	$ 5,900	$ 6,700

At December 31, 2007 and 2008, we had deferred revenue balances of $7.4 million and $4.2 million, respectively, related to the Alcon agreement which was comprised of $6.7 million and $4.2 million, respectively, for the upfront technology access fee and $0.7 million and $0, respectively, for other prepaid reimbursements. As of December 31, 2008, we had not received any milestone or royalty payments under the Alcon 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.

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Revenue has been recognized as follows:

	Year Ended December 31,		
	2006	2007	2008
(in thousands)			
Amortization of Upfront Technology Access Fee	$ -	$ 72	$ 128
On-going Research and Development	-	29	8
Materials, Equipment, and Contract Study Costs	-	-	-
	$ -	$ 101	$ 136

We had deferred revenue balances of $128,000 and $0, respectively, at December 31, 2007 and 2008, related to the KCI agreement, which consisted of the remaining amount to be amortized for the upfront technology access fee. As of December 31, 2008, 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, 2008.

NOTE 13. INCOME TAXES

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

	Year Ending December 31		
	2006	2007	2008
United States	$ (5,126)	$ (5,388)	$ (8,112)
International	-	-	-
	$ (5,126)	$ (5,388)	$ (8,112)

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

	Year Ending December 31		
	2006	2007	2008
Current			
Federal	$ -	$ -	$ -
State	-	12	2
Other			
Total Current Tax Expense	-	12	2
Deferred			
Federal	-	-	-
State	-	-	-
Other	-	-	-
Total Deferred Tax Expense	-	-	-

Total Tax Expense	$	-	$	12	$	2

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

		Year Ending December 31	
		2007	2008
Deferred Tax Assets:			
	Accruals	$ 264	$ 409
	Deferred Revenue	2,655	1,660
	Net Operating Losses	4,040	7,946
	Stock Options	310	176
	Other Deferred Tax Assets	25	45
	Total Deferred Tax Assets	$ 7,294	$ 10,236
Deferred Tax Liabilities:			
	Property, Plant & Equipment	(88)	(228)
	Total Deferred Tax Liabilities	(88)	(228)
Valuation Allowance		(7,206)	(10,008)
Net Deferred Taxes		$ -	$ -

SFAS No. 109 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 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

2006	2007	2008
	(In thousands)	
$ 2,111	$ 1,997	$ 2,978

We track the portion of our federal and state net operating loss carryforwards attributable to stock option benefits in a separate memo account pursuant to FAS 123R. Therefore, these amounts are not included in gross or net deferred tax assets.
Pursuant to FAS 123R, 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, 2008 are as follows:

In thousands		Amount	Expiration Years
Net operating losses, federal	$	19,972	2024 - 2028
Net operating losses, state	$	19,797	2014 - 2028
Tax credits, federal	$	-	
Tax credits, state	$	8,223	N/A

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

	Year Ending December 31		
	2006	2007	2008
Statutory Rate	$ (1,743)	$ (1,832)	$ (2,758)
State Tax	(297)	(274)	(435)
ISO Related Expense for GAAP	-	81	207
Change in Valuation Allowance	2,111	1,997	2,978
Other	(71)	40	10
			-
			-
			-
Total	$ -	$ 12	$ 2

Uncertain Income Tax Positions

In July 2006, the FASB released Interpretation No. 48 "Accounting for Uncertainty in Income Taxes" ("FIN 48"). FIN 48 prescribes the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also requires additional disclosure of the beginning and ending unrecognized tax benefits and details regarding the uncertainties that may cause the unrecognized benefits to increase or decrease within a twelve month period.

We adopted the provisions of FIN 48 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, 2008, 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 2002 forward. We do not anticipate that total unrecognized tax benefits will significantly change prior to December 31, 2009.

NOTE 14. SUBSEQUENT EVENTS

In January 2009, the FDA approved 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 has triggered the immediate payment of the first milestone of $1,000,000 from Alcon.

On February 2, 2009, the Company filed a registration statement on Form S-8 to register an aggregate of 858,766 additional shares of the Company's common stock to be issued under the Company's 2007 Omnibus Incentive Plan, as amended and restated.

In January 2009, the Company issued refresh grants of incentive stock options to its employees.

On March 25, 2009, the Company announced that it has entered into an agreement with Galderma S.A. to develop and commercialize the Company's novel proprietary Aganocide® compounds. The exclusive agreement is worldwide in scope, except in certain Asian markets, and covers all major dermatological conditions, excluding onychomycosis (nail fungus) and orphan drug indications.

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.

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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.

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, 2008. 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, 2008, 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 2008, there were no changes in our internal control over financial reporting, identified by our Chief Executive Officer or our Chief Financial Officer in connection with the evaluation of the effectiveness of our disclosure controls and procedures, which has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

Not applicable.

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 2009 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 and procedures for Board nominations, is incorporated herein by reference from the information under the caption, "Proposal One: Election of Directors" 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.

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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 "Proposal 1: Election of Directors – Code of Ethics and Business Conduct" 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.

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(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.

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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 31, 2009	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 30, 2009
/S/ THOMAS PAULSON Thomas J. Paulson	Chief Financial Officer and Treasurer (principal financial and accounting officer)	March 31, 2009
/S/ CHARLES J. CASHION Charles J. Cashion	Director	March 31, 2009
/S/ ANTHONY DAILLEY Anthony Dailley, DDS	Director	March 30, 2009
/S/ PAUL FREIMAN Paul E. Freiman	Director	March 30, 2009
/S/ ALEX MCPHERSON Alex McPherson, MD, Ph.D.	Director	March 30, 2009
/S/ ROBERT R. TUFTS Robert R. Tufts	Director	March 30, 2009

/S/ TONY WICKS Tony Wicks	Director	March 30, 2009
/S/ HARRY F. HIXSON, JR., PhD Harry F. Hixson	Director	March 30, 2009

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EXHIBIT INDEX

Exhibit No.	Description
3.1	Amended and Restated Articles of Incorporation of registrant (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.)
3.2	Amended and Restated Bylaws of registrant (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.)
4.1*	Specimen common stock certificate
4.2*	Form of Registration Rights Agreement by and between the Registrant and the underwriters
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 (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.), and forms of agreements thereto.)
10.4*+	Employment Agreement dated January 1, 2007 by and between the Registrant and Ramin ("Ron") Najafi
10.5*+	Employment Agreement dated January 1, 2007 by and between the Registrant and John ("Jack") O'Reilly
10.6*+	Employment Agreement dated January 1, 2007 by and between the Registrant and Behzad Khosrovi
10.7*+	Employment Agreement dated January 1, 2007 by and between the Registrant and Colin Scott
10.8*+	Employment Agreement dated January 9, 2008 by and between the Registrant 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.)
10.9+	Retirement and Consulting Agreement dated January 1, 2009 by and Between the Registrant and John ("Jack") O'Reilly
10.10*	Office Lease dated June 3, 2004 by and between the Registrant 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 Registrant and Emery Station Associates II, LLC, as amended (Incorporated by reference to Exhibit 10.19 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.)
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.)
10.13*	License Agreement dated June 11, 2007 by and between the Registrant and KCI International VOF GP
10.14*	Financial Advisory and Investor Relations Consulting Agreement dated February 13, 2007 by and between the Registrant and PM Holdings Ltd
10.15*	Director Compensation Plan
10.11*†	Collaboration and License Agreement dated August 29, 2006 by and between the Registrant and Alcon Manufacturing, Ltd.
10.16*	Master Security Agreement dated April 23, 2007 by and between the Registrant and General Electric Capital Corporation
10.17*	Form of Common Stock Purchase Warrant by and between the Registrant and the underwriters
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 number from the Company's registration statement of Form S-1 (File No. 333-138379) initially filed with the Securities and Exchange Commission on November 2, 2006, 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.