INTRABIOTICS PHARMACEUTICALS INC /DE
Form 10-Q
July 28, 2006

Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
Form 10-Q

þ **Quarterly report pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934**
For the quarterly period ended June 30, 2006

Or

o **Transition report pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934**
For the transition period from to

Commission File Number 0-29993
INTRABIOTICS PHARMACEUTICALS, INC.
(Exact name of Registrant as specified in its charter)

DELAWARE	94-3200380
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

1009 Oak Hill Rd., Suite 201
Lafayette, CA 94549
(Address of principal executive offices)
(925) 906-5331
(Registrant s telephone number including area code)

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

Indicate by checkmark whether registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (check one)

Large accelerated filer o Accelerated filer o Non-accelerated filer þ

Indicate by check mark whether the registrant is shell company (as defined in Rule 12b-2 of the Securities Exchange Act of 1934).
Yes þ No o

There were 9,321,444 shares of the Registrant s common stock, par value $0.001, outstanding as of June 30, 2006.

Table of Contents

TABLE OF CONTENTS
INTRABIOTICS PHARMACEUTICALS, INC.
FORM 10-Q
QUARTER ENDED JUNE 30, 2006
TABLE OF CONTENTS

	Page
PART I. FINANCIAL INFORMATION	
Item 1. Financial Statements	3
Condensed Balance Sheets as of June 30, 2006 (unaudited) and December 31, 2005	3
Condensed Statements of Operations for the Three and Six Months Ended June 30, 2006 and 2005 (unaudited)	4
Condensed Statements of Cash Flows for the Six Months Ended June 30, 2006 and 2005 (unaudited)	5
Notes to Condensed Financial Statements	6
Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations	11
Item 3. Quantitative and Qualitative Disclosure About Market Risk	15
Item 4. Controls and Procedures	15
PART II. OTHER INFORMATION	17
Item 1. Legal Proceedings	17
Item 1A. Risk Factors	17
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	18
Item 3. Defaults Upon Senior Securities	18
Item 4. Submission of Matters to a Vote of Security Holders	18
Item 5. Other Information	18
Item 6. Exhibits	18
SIGNATURES	19
EXHIBIT INDEX	20
EXHIBIT 31.1	
EXHIBIT 32.1	

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements

INTRABIOTICS PHARMACEUTICALS, INC.
CONDENSED BALANCE SHEETS
(Dollars In thousands, except per share data)

	June 30, 2006 (Unaudited)	December 31, 2005 (Note 1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 577	$ 2,772
Short-term investments	47,823	46,058
Prepaid expenses and other current assets	747	341
Total current assets	49,147	49,171
Total assets	$ 49,147	$ 49,171
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 33	$ 58
Accrued clinical liabilities	7	99
Other accrued liabilities	136	194
Total current liabilities	176	351
Stockholders equity:		
Convertible preferred stock, $0.001 par value: 5,000,000 shares authorized; 300 shares outstanding and $3,000 aggregate liquidation preference at June 30, 2006 and December 31, 2005, respectively	1,634	1,634
Common stock, $0.001 par value: 70,000,000 shares authorized at June 30, 2006 and December 31, 2005; 9,321,444 and 9,287,685 shares outstanding at June 30, 2006 and December 31, 2005, respectively	9	9
Additional paid-in capital	283,157	282,828
Deferred stock compensation		(45)
Accumulated other comprehensive loss	(11)	(36)
Accumulated deficit	(235,818)	(235,570)
Total stockholders equity	48,971	48,820
Total liabilities and stockholders equity	$ 49,147	$ 49,171

See accompanying notes

Table of Contents

INTRABIOTICS PHARMACEUTICALS, INC.
CONDENSED STATEMENTS OF OPERATIONS
(In thousands, except per share amounts)
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	**2005**	**2006**	**2005**
Operating expenses:				
Research and development	$	$ 59	$ 7	$ 248
General and administrative	554	851	1,214	2,045
Restructuring charge		675		675
Total operating expenses	554	1,585	1,221	2,968
Operating loss	(554)	(1,585)	(1,221)	(2,968)
Other income (expense)			(1)	
Interest income	577	339	1,095	648
Net income (loss)	23	(1,246)	(127)	(2,320)
Non-cash dividends on Series A preferred stock	(60)	(60)	(120)	(120)
Net loss applicable to common stockholders	$ (37)	$ (1,306)	$ (247)	$ (2,440)
Basic and diluted net loss per share applicable to common stockholders	$ (0.00)	$ (0.14)	$ (0.03)	$ (0.27)
Shares used to compute basic and diluted net loss per share applicable to common stockholders	9,315	9,089	9,307	9,040

See accompanying notes

Table of Contents

INTRABIOTICS PHARMACEUTICALS, INC.
CONDENSED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005
Operating activities		
Net loss	$ (127)	$ (2,320)
Adjustments to reconcile net loss to net cash used in operating activities:		
Stock compensation for directors	257	
Stock compensation for variable option awards		(48)
Amortization of deferred stock compensation		28
Stock compensation for consultant services	2	125
Depreciation and amortization		9
Loss on disposal of property and equipment		27
Change in assets and liabilities:		
Prepaid expenses and other current assets	(406)	(150)
Accounts payable	(25)	(109)
Accrued clinical liabilities	(92)	(69)
Accrued employee liabilities		(89)
Accrued restructuring charges		34
Other accrued liabilities	(58)	(73)
Net cash used in operating activities	(449)	(2,635)
Investing activities		
Proceeds from sale of property and equipment		10
Purchase of short term investments	(121,877)	(50,877)
Proceeds from sale or maturity of short-term investments	120,131	59,550
Net cash provided by (used in) investing activities	(1,746)	8,683
Financing activity		
Proceeds from issuance of common stock, net of issuance costs		49
Net cash provided by financing activities		49
Net increase (decrease) in cash and cash equivalents	(2,195)	6,097
Cash and cash equivalents at beginning of the period	2,772	1,755
Cash and cash equivalents at end of the period	$ 577	$ 7,852
Supplemental disclosure of non-cash information:		
Issuance of common stock dividend on Series A preferred stock	$ (120)	$ (120)

Issuance of common stock upon conversion of Series A preferred stock	$	$ (137)

See accompanying notes

INTRABIOTICS PHARMACEUTICALS, INC.
NOTES TO CONDENSED FINANCIAL STATEMENTS
(Unaudited)

Note 1. Basis of Presentation and Summary of Significant Accounting Policies

The accompanying condensed financial statements are unaudited and have been prepared by IntraBiotics Pharmaceuticals, Inc. (the Company) in accordance with the rules and regulations of the Securities and Exchange Commission for interim financial information, and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X.

Certain information and footnote disclosures normally included in the Company s annual audited financial statements (as required by accounting principles generally accepted in the United States) have been condensed or omitted. The interim condensed financial statements, in the opinion of management, reflect all adjustments (consisting entirely of normal recurring adjustments) necessary for a fair presentation of the Company s financial position as of June 30, 2006, the results of its operations for the three months and six months ended June 30, 2006 and 2005 and cash flows for the six months ended June 30, 2006 and 2005.

The results of operations for the interim periods are not necessarily indicative of the results of operations to be expected for the entire fiscal year. These interim condensed financial statements should be read in conjunction with the audited financial statements for the year ended December 31, 2005, which are contained in the Company s Annual Report on Form 10-K, and filed with the Securities and Exchange Commission on February 21, 2006. The condensed balance sheet as of December 31, 2005 is derived from such audited financial statements.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes, including amounts accrued for stock-based compensation.

The Company s estimate of accrued costs is based on historical experience, information received from third parties and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results could therefore differ materially from those estimates under different assumptions or conditions.

Note 2. Stock-Based Compensation

The Company s 2004 Stock Incentive Plan (the 2004 Plan) was adopted in May 2004, and replaced the 2000 Equity Incentive Plan (the 2000 Plan), which in turn had replaced the 1995 Incentive Stock Plan (the 1995 Plan), collectively the Predecessor Plans. The termination of the Predecessor Plans had no effect on the options that were granted thereunder. The terms of awards granted under the Predecessor Plans were substantially similar to those granted under the 2004 Plan. The 2004 Plan allows for the granting of options to purchase stock, stock bonuses and rights to acquire restricted stock of up to 2,050,000 shares of common stock to employees, consultants, and directors. The number of shares of Common Stock available for issuance under the Plan shall automatically increase on the first trading day of January each calendar year during the term of the Plan, beginning with calendar year 2005. In accordance with the preceding formula, the shares available for issuance under the 2004 Plan were increased by 529,510 on January 1, 2005 and 543,302 on January 1, 2006. All options granted under the 2004 Plan must have exercise prices equal to the fair market value of the common stock on the option grant date, and are to have a term not greater than 10 years from the grant date. Options granted under the 2004 plan vest ratably over a periods ranging from 3 months to six years. Options granted under Predecessor Plans vest ratably over periods ranging from 18 months to six years.

The 2002 Non-Officer Equity Incentive Plan (the 2002 Plan) was adopted in August 2002 and allows the granting of stock awards, stock bonuses and rights to acquire restricted common stock of up to 208,333 shares of common stock, to employees of the Company who are not officers, to executive officers not previously employed by the Company as an inducement to entering into an employment contract with the Company, and to consultants of the Company. All options are to have a term not greater than 10 years from the grant date.

To cover the exercise of vested options the Company issues new shares from its authorized but unissued share pool. As of June 30, 2006 there were 2,521,310 and 56,250 shares of common stock available for issuance under the 2004 Plan and the 2002 Plan, respectively.

No cash proceeds from the sales of common stock under employee option plans were received for the six months ended June 30, 2006, versus $49,000 during the first six months of 2005. No income tax benefits were realized from the sales of common stock during the six months ended June 30, 2006. In accordance with SFAS 123 (R), the Company presents excess tax benefits from the exercise of stock options, if any, as financing cash flows rather than operating cash flows.

Adoption of SFAS No. 123 (R)

Effective January 1, 2006, the Company adopted Financial Accounting Standards Board Statement of Financial Accounting Standards (SFAS) 123(R) - Share-Based Payment , a revision of SFAS 123, Accounting for Stock-Based Compensation which superseded Accounting Principles Board (APB) Opinion No.25, Accounting for Stock Issued to Employees, and its related implementation guidance. SFAS 123(R) establishes standards for the accounting for transactions where an entity exchanges its equity instruments for goods or services. The principal focus of SFAS 123(R) is the accounting for transactions in which an entity obtains employee services in share-based payment transactions, and where the measurement of the cost of employee (or member of the Board of Directors) services received in exchange for an award of equity instruments is based on the grant-date fair value of the award. That cost will be recognized over the period during which an employee (or director) is required to provide service in exchange for the award the requisite service period and unless observable market prices for the same or similar instruments are available, will be estimated using option-pricing models adjusted for the unique characteristics of the instruments. If an equity award is modified after the grant date, incremental compensation cost will be recognized in an amount equal to the excess of the fair value of the modified award over the fair value of the original award immediately before the modification.

Stock Compensation Expense

Under SFAS 123R, we determined the appropriate fair value model to be used for valuing share-based payments and the amortization method for compensation cost. The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006. The Company s Consolidated Financial Statements as of and for the three months and six months ended June 30, 2006 reflects the impact of SFAS 123(R). During the three months and six months ended June 30, 2006, the Company recognized $125,000 and $257,000, respectively, in compensation expense related to options granted to employees and directors, which was $108,895 and $224,800 higher than if it had continued to account for share-based compensation under Statement 123. There were no tax benefits from share-based compensation since the company sustained a loss for both the three months and six months ended June 30, 2006. In accordance with the modified prospective transition method, the Company s Consolidated Financial Statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). The impact on both basic and diluted earnings per share for the three months and six months ended June 30, 2006 was $0.01 and $0.03, respectively.

Prior to 2006, the Company accounted for stock-based compensation in accordance with APB 25 using the intrinsic value method, which did not require that compensation cost be recognized for the Company s stock awards provided the exercise price was established at 100% of the common stock fair market value at the date of grant. Prior to fiscal 2006 the company provided pro forma disclosure amounts in accordance with SFAS No. 148, Accounting for Stock-Based Compensation - Transition and Disclosure, as if the fair value method defined by SFAS 123 had been applied to its stock-based compensation. If the Company had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation for the three and six months ended June 30, 2005, it would have recorded an expense of $518k and $1.4 million, respectively. The difference between the two years (actual 2006 and pro-forma 2005) is primarily due to the decreased volatility of the stock and option exercises and cancellations resulting from the discontinuance of Iseganan and subsequent termination of all employees. The impact on both basic and diluted earnings per share for the three months and six months ended June 30, 2005 was $0.06 and $0.15, respectively.

At June 30, 2006, the total compensation cost related to unvested stock-based awards granted to employees under the stock option plans but not yet recognized was approximately $496,678, after estimated forfeitures. The cost will be

recognized on a straight-line basis over an estimated weighted average period of approximately 3.7 years for stock options and will be adjusted if necessary for forfeitures and cancellations.

Table of Contents

Determining Fair Value

Valuation and amortization method The Company estimates the fair value using a Black-Scholes option pricing formula and a single option award approach. This fair value is then amortized ratably over the requisite service periods of the awards, which is generally the vesting period.

Expected term The expected term of options is derived from the output of the option valuation model and represents the period of time that options granted are expected to be outstanding; which results from certain groups of employees exhibiting different behavior.

Expected Volatility The Company s expected volatility for the quarter ended June 30, 2006 is based on Company s historical volatility.

Risk-Free Interest Rate The risk-free interest rate used in the Black-Scholes option valuation method is based on the implied yield currently available on U.S. Treasury zero-coupon issues with a remaining term equal to the expected term of the option.

Expected Dividend The dividend yield reflects that the Company has not paid any dividends and has no intention to pay dividends in the foreseeable future.

Estimated Forfeiture The Company does not anticipate forfeiture due to the limited number of people (4) that have stock options outstanding.

In the three months ended June 30, 2006 and 2005, respectively, the fair value of each option grant was estimated on the date of grant using the Black-Scholes option valuation model using a dividend yield of 0% and the following weighted average assumptions:

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2006	**2005**	**2006**	**2005**
Risk-free interest rate	n/a	n/a	5.16%	3.79%
Volatility	n/a	n/a	0.20	0.89
Dividend yield	n/a	n/a	0.00%	0.00%
Expected life of option	n/a	n/a	1.7	6.1

No stock options were granted to employees during the three months ended June 30, 2006 and 2005. There were no post-vesting restrictions.

Stock Options and Awards Activities

The following is a summary of the Company s stock option activity under the stock option plans as of June 30, 2006 and related information:

	Outstanding Options			
		Weighted Average		Aggregate
	Number of Shares	Exercise Price	Remaining Contract Life	Intrinsic Value (000 s)
Balance at December 31, 2005	570,667	$8.92	7.08	
Granted	37,500	$3.50		
Exercised				
Forfeitures and cancellations	(65,000)	$9.98		
Balance at June 30, 2006	543,167	$8.34	6.63	$184,550
Vested and expected to Vest at June 30, 2006	543,167	$8.34	6.63	$184,550
Exercisable at June 30, 2006	386,076	$7.98	6.63	$152,795

8

The weighted-average grant date fair value of options granted for both the three months and six months periods ended June 30, 2005 and 2006 was $3.93 and $3.50, respectively. The aggregate intrinsic value in the table above represents the total pretax intrinsic value, based on the Company s closing stock price of $3.60 at June 30, 2006, which would have been received by option holders had all option holders exercised their options that were in-the-money as of that date. The total number of in-the-money options exercisable as of June 30, 2006 was approximately 178,327 shares. The aggregate intrinsic value of options exercised during the three and six months ended June 30, 2006 was zero, since there were no options exercised.

The exercise prices for options outstanding and exercisable as of June 30, 2006 and their weighted average remaining contractual lives were as follows:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number of Shares	Weighted-Average Remaining Contractual Life (years)	Weighted Average Exercise Price	Number of Shares	Weighted-Average Exercise Price
$2.40 2.76	211,667	4.3	$ 2.75	178,327	$ 2.74
$3.80 4.08	77,500	9.1	$ 3.73	40,000	$ 3.94
$13.06 16.49	254,000	7.8	$14.42	167,749	$14.53
	543,167	7.1	$ 8.92	386,076	$ 8.14

Pro-forma Disclosures

The following table illustrates the effect on net income and net income per share as if we had applied the fair value recognition provisions of SFAS No. 123 to stock-based compensation during the three-month and six month periods ended June 30, 2005 (in thousands, except per share amounts):

	(In thousands, except per share amounts)	
	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net loss applicable to common stockholders, as reported	$ (1,306)	$ (2,440)
Add: Stock-based employee compensation expense (recovery) included in reported net loss applicable to common stockholders	11	(20)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards	(529)	(1,363)
Net loss applicable to common stockholders, pro forma	$ (1,824)	$ (3,823)
Net loss per share applicable to common stockholders:		
Basic and diluted as reported	$ (0.14)	$ (0.27)
Basic and diluted pro forma	$ (0.20)	$ (0.42)

For the purposes of this pro forma disclosure, the value of the options was estimated using a Black-Scholes option valuation model and recognized over the respective vesting periods of the awards.

Table of Contents

Note 3. Comprehensive Loss

The components of comprehensive loss in each period presented are as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
	(In thousands)		(In thousands)	
Net Income (loss)	$ 23	$ (1,246)	$ (127)	$ (2,320)
Unrealized gain (loss) on available-for-sale securities	9	51	25	(2)
Comprehensive loss	$ 32	$ (1,195)	$ (102)	$ (2,322)

Note 4. Net Loss Per Share

Basic and diluted net loss per share applicable to common stockholders is presented in accordance with Financial Accounting Standards Board Statement No. 128, *Earnings Per Share,* and is calculated using the weighted-average number of shares of common stock outstanding during the period. Net profit or loss per share applicable to common stockholders includes the impact of potentially dilutive securities (stock options, warrants and convertible preferred stock). As the Company s potentially dilutive securities were anti-dilutive for all periods presented, they are not included in the calculations of diluted net loss per share applicable to common stockholders. The total number of shares underlying the stock options, warrants and convertible preferred stock excluded from the calculations of net loss per share applicable to common stockholders was 2,540,819 and 3,233,024 for the three months ended June 30, 2006 and 2005, respectively and 2,530,703 and 3,280,453 for the six months ended June 30, 2006 and 2005.

Note 5. Stockholders Equity

In February 2005, a holder of 25 shares of Preferred Stock converted the shares into 131,529 shares of common stock. At the same time, the same investor exercised warrants to purchase 65,764 shares of common stock, using the net exercise method, resulting in the issuance of 30,704 shares of common stock. There were no cash proceeds to the Company resulting from these transactions.

On October 14, 2005, the Company s Stock was delisted from The NASDAQ National Market. The delisting decision was made by the NASDAQ Listings Qualifications Panel, following an appeal by the Company of a prior determination by the staff of the NASDAQ Stock Market (the Staff) that the Company was a public shell, raising public interest concerns pursuant to Marketplace Rule 4300.

As previously disclosed, the Company issued warrants to purchase shares of its common stock in connection with its Series A convertible preferred stock offering on May 1, 2003 which provide that if the Company s common stock is delisted from NASDAQ, the purchase price for the stock upon exercise of the warrants will be reduced by 50% without any concomitant increase in the number of shares of common stock for which the warrants are then exercisable. This provision was triggered by the delisting. As of September 30, 2005 the Company had 789,171 such warrants outstanding with an exercise price of $2.066 per share. As a result of the October 14, 2005 delisting, the exercise price dropped from $2.066 to $1.033 per share, and the Company recorded a non-cash charge to other expense resulting from the change in exercise price and an offsetting increase to paid-in-capital in December of 2005 in the amount of $789,000 to reflect the fair market value.

The Company s quotation for its common stock appears in the Pink Sheets under the trading symbol IBPI or IBPI.PK .

In February 2006, the Company issued 16,580 shares of common stock in connection with dividends payable to holders of preferred stock on December 31, 2005. In May 2006, the Company issued 17,179 shares of common stock in connection with dividends payable to holders of preferred stock on December 31, 2005.

Table of Contents

Note 6. Commitments

At June 30, 2006, the Company had no operating lease commitments.

Note 7. Legal Proceedings

Beginning on July 2, 2004, three purported class action shareholder complaints were filed in the United States District Court for the Northern of California against IntraBiotics and several of its officers. The actions were consolidated and a consolidated amended complaint has been filed, purportedly brought on behalf of purchasers of IntraBiotics common stock between September 5, 2003 and June 22, 2004. The amended complaint generally alleges that IntraBiotics and several of its officers and directors made false or misleading statements concerning the clinical trial of Iseganan. The plaintiffs seek unspecified monetary damages. On February 28, 2005, the Company and the individual defendants filed a motion to dismiss the amended complaint. On January 23, 2006, the court issued its decision on the motion, granting the motion to dismiss the claim under the Securities Exchange Act of 1934, with leave to amend, and denying the motion to dismiss the claims under the Securities Act of 1933. Plaintiffs filed an amended complaint on February 22, 2006. IntraBiotics and the other defendants moved to dismiss the amended complaint on March 14, 2006.

The Company believes the suit to be without merit and intends to defend itself vigorously. However, the Company believes it is likely that the litigation will continue through at least the end of 2006. Due to the uncertainties surrounding the final outcome of this matter, no amounts have been accrued at June 30, 2006. The Company and the individual defendants are insured under the Company s directors and officers insurance policies, with $15 million in total coverage, and a $500,000 deductible, which has been met and the expense recorded in prior years. However, the Company may incur expenses in the defense or disposition of the litigation beyond what is covered by insurance.

ITEM 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of our financial condition and results of operations should be read together with our financial statements and related notes included in our quarterly report on this Form 10-Q and in our annual report on Form 10-K for the year ended December 31, 2005. This discussion and analysis contains forward-looking statements that involve risks, uncertainties and assumptions. The actual results may differ materially from those anticipated in these forward-looking statements as a result of many factors, including but not limited to those set forth in Part1, Item 1A Risk Factors of our Form 10-K for the year ended December 31, 2005. All forward-looking statements included in this document are based on information available to us on the date of this document and we assume no obligation to update any forward-looking statements contained in this Form 10-Q.

Overview

From inception in 1994, through May 2005, we devoted substantially all of our efforts to research and development of anti-microbial drugs, and generated no product revenues. From the fourth quarter of 2002 until June 2004 we focused our attention on developing Iseganan for the prevention of ventilator-associated pneumonia (VAP). In June 2004, the Company discontinued its clinical trial of Iseganan for the prevention of VAP following a recommendation of the independent data monitoring committee. Subsequently, the Company terminated the Iseganan development program, reduced employees, and evaluated (and continues to evaluate) strategic alternatives, including mergers, acquisitions, in-licensing opportunities, and liquidation of the Company. The Company, in any case, will continue operations until the conclusion of the securities litigation class action lawsuit described below in Part II, Item 1, Legal Proceedings and under Part 1, Item 1A Risk Factors of our Form 10-K for the fiscal year ended December 31, 2005.

On May 5, 2005, after considering a variety of strategic alternatives, none of which was determined by management and the Board of Directors to be in the best interests of the Company and its shareholders, the Board of Directors decided to suspend the Company s active evaluation process and reduce operating expenses to a minimum appropriate level. In accordance with these plans, the Company terminated all of its remaining regular employees on June 15, 2005. The Company will continue to pursue strategic alternatives in the biotechnology industry with the support of consultants and the active participation of its Board. In addition, the Company engaged Hickey & Hill, Inc. of Lafayette, California, a firm specializing in managing companies in transition, to assume the responsibilities of day-to-day administration of the Company, and appointed Denis Hickey of Hickey & Hill, Inc. as its Chief Executive Officer and Chief Financial Officer.

The registrant plans to conduct its affairs in the most financially efficient manner practical for a public company. During the period that Hickey & Hill, Inc. will handle the administration of the Company s affairs, the Board of Directors and selected consultants will evaluate any strategic alternatives that come to the Company s attention.

On June 30, 2006, the Company had a total of $48.4 million in cash, cash equivalents, and short-term investments, and recorded liabilities of $0.2 million. Based on current projections, the Company expects cash outflows between $0.5 million and $1.0 million during 2006. This estimate does not include any costs that may be associated with completing a merger, acquisition, in-license opportunity, liquidation of the Company or the disposition of the securities litigation referred to in Part II, Item 1 of this Form 10-Q (the Securities Litigation). There can be no assurance that such a range will be achieved, as actual expenditures and interest income may differ significantly from projected levels.

We have granted stock options to consultants, which resulted in stock compensation expense of $0 and $2,000 during the three and six months ended June 30, 2006, respectively, and $69,000 and $125,000 during the three and six months ended June 30, 2005, respectively.

We intend that the following discussion of our results of operations and financial condition will provide information to assist in the understanding of our financial statements, the changes in certain key items in those financial statements from year to year, and the primary factors that accounted for those changes, as well as how certain accounting principles, policies and estimates affect our financial statements.

Critical Accounting Policies and Estimates

An accounting policy is deemed to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimate is made, and if different estimates that reasonably could have been used, or changes in the accounting estimates that are reasonably likely to occur periodically, could materially impact the financial statements. Management believes the following critical accounting policies reflect its more significant estimates and assumptions used in the preparation of the financial statements. We review the accounting policies used in our financial statements on a regular basis. In addition, management has reviewed these critical accounting policies and related disclosures with our Audit Committee.

Our discussion and analysis of our financial condition and results of operations is based upon our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities and expenses, and related disclosures. On an ongoing basis, we evaluate these estimates, including those related to clinical trial accruals, income taxes, restructuring costs and stock-based compensation. Estimates are based on historical experience, information received from third parties and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results could therefore differ materially from those estimates under different assumptions or conditions.

Stock-Based Compensation

As permitted by Statement of Financial Accounting Standards No. 123 (SFAS 123), *Accounting for Stock-Based Compensation* , as amended by Statement of Financial Standards No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure,* the Company elected to follow APB 25 and related interpretations in accounting for stock-based employee compensation through December 31, 2005. Under APB 25, if the exercise price of an employee or director stock option is set equal or in excess of the fair market value of the underlying stock on the date of grant, no compensation expense is recognized. In February 2003, certain employee and director stock options for which the exercise prices had originally been set at less than the fair market value of the underlying stock on the grant date, were cancelled and re-granted in a one-for-one exchange. The Company had recorded deferred compensation for the difference between the original exercise price and the fair market value of the underlying stock on the grant date as a component of stockholders equity, and the total was being amortized on a straight-line basis over the vesting period of the original awards, ranging from four to six years. The related re-granted options all vest over a four-year period, and the remaining unamortized deferred compensation as of the re-grant date is now being amortized over the new four-year vesting schedule, commencing at the date of re-grant. The amount of deferred stock compensation expense to be recorded in future periods could decrease if options, for which accrued but unvested compensation has been recognized, are forfeited prior to vesting. No adjustments for material changes in estimates have been recognized in any period presented.

Effective January 1, 2006, the Company adopted Financial Accounting Standards Board Statement of Financial Accounting Standards (SFAS) 123(R) - Share-Based Payment , a revision of SFAS 123, Accounting for Stock-Based Compensation which superseded Accounting Principles Board (APB) Opinion No.25, Accounting for Stock Issued to Employees, and its related implementation guidance on August 1, 2005. SFAS 123(R) establishes standards for the accounting for transactions where an entity exchanges its equity instruments for goods or services. The principal focus of SFAS 123(R) is the accounting for transactions in which an entity obtains employee services in share-based payment transactions, and where the measurement of the cost of employee (or member of the Board of Directors) received in exchange for an award of equity instruments is based on the grant-date fair value of the

Table of Contents

award. That cost will be recognized over the period during which an employee (or director) is required to provide service in exchange for the award the requisite service period and unless observable market prices for the same or similar instruments are available, will be estimated using option-pricing models adjusted for the unique characteristics of the instruments. If an equity award is modified after the grant date, incremental compensation cost will be recognized in an amount equal to the excess of the fair value of the modified award over the fair value of the original award immediately before the modification.

Under SFAS 123R, we determined the appropriate fair value model to be used for valuing share-based payments and the amortization method for compensation cost. The Company adopted SFAS 123(R) using the Black-Scholes modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006. The Company s Consolidated Financial Statements as of and for the three and six months ended June 30, 2006 reflects the impact of SFAS 123(R). During the three and six months ended June 30, 2006, the Company recognized $125,000 and $257,000, respectively in compensation expense related to options granted employees and directors. In accordance with the modified prospective transition method, the Company s Consolidated Financial Statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). If the Company had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation for the three and six months ended June 30, 2005, it would have recorded an expense of $518,000 and $1.4 million, respectively. The difference between the two years is primarily due to the decreased volatility of the stock and option exercises and cancellations resulting from the discontinuance or Iseganan and subsequent termination of all employees.
1997

2018

Additional information regarding the nominees for election as directors and the continuing directors of the Company, including a description of the specific experience, qualifications, attributes and skills that led the Board of Directors to conclude that each individual should serve as a director, is set forth below.

Nominees

Cecil D. Conlee is a partner of CGR Advisors, an Atlanta, Georgia based real estate investment advisory firm that he founded in 1990. He served as a director of Oxford Industries, Inc., an international apparel design, sourcing and marketing company from 1985 until June 2011, and was a member of the Executive Committee and Chairman of the Audit Committee. He also served as a director of Central Parking Corp. from 1996 to 2006. Mr. Conlee has been a member of the Company’s Strategic Planning Committee since 1995 and was a lead director of Burnup & Sims Inc. (a former affiliate of the Company) for more than 20 years. As a result, he gained unique knowledge and experience during the formative years of the Company. In addition, Mr. Conlee holds an MBA from Harvard University and is a Trustee Emeritus of Vanderbilt University. Mr. Conlee’s education, business acumen, leadership skills, civic involvement and his knowledge and experience related to our Company qualify him to serve on our Board.

Stanley M. Sheridan was employed by Faygo Beverages, Inc., a wholly-owned subsidiary of National Beverage Corp., from 1974 until his retirement in 2004. He joined Faygo Beverages, Inc. as Chief Financial Officer in 1974 and was promoted to President in May 1987 when Faygo Beverages, Inc. was acquired by National Beverage Corp. He holds

an MBA in Accounting and has served on the boards of various private companies and charitable organizations. Mr. Sheridan's retirement in 2004 and his absence from Faygo Beverages, Inc. qualify him as an independent director for the Company. Mr. Sheridan's 30 years of experience in the beverage industry and his professional management expertise as a chief executive in the soft drink industry make him extremely familiar with our business. These qualifications and his financial and accounting expertise qualify him to serve on our Board.

Continuing Directors

Nick A. Caporella has served as Chairman of the Board and Chief Executive Officer of the Company since the Company was founded in 1985. He also served as President until September 2002. Since January 1992, Mr. Caporella's services have been provided to the Company through a management company, Corporate Management Advisors, Inc. ("CMA"), an entity which he owns. (See "Management Services Agreement – Compensation" and "Certain Relationships and Related Party Transactions".) Mr. Caporella previously served as President and Chief Executive Officer (since 1976) and Chairman of the Board (since 1979) of Burnup & Sims Inc. until March 1994. Throughout his more than 50-year business career, he has founded or managed as the Chief Executive Officer successful companies and has served as a public company Chairman, Chief Executive Officer or President since 1976. Mr. Caporella has achieved many awards as a businessman, including induction into the Institute of American Entrepreneurs and receipt of the Horatio Alger Award. He is involved in many research projects which endeavor to advance the cure of children's cancer and currently serves on the Professional Advisory Board of St. Jude Children's Hospital. The Company was founded as a result of Mr. Caporella's vision and entrepreneurial spirit and his extraordinary career, entrepreneurial spirit, business acumen and civic leadership qualify him to serve on the Board.

Joseph G. Caporella has served as President of the Company since September 2002 and, prior to that date, served as Executive Vice President since January 1991. He is the son of Mr. Nick A. Caporella. Since joining the Company in 1988, he has been involved in all aspects of the Company's operations, including procurement, supply chain management, distribution and sales leadership. Mr. Caporella's more than 25 years of experience in the beverage industry coupled with his extensive knowledge of the day-to-day business operations of the Company qualify him to serve on our Board.

Samuel C. Hathorn, Jr. was employed by Trendmaker Homes, Inc. from 1981 until his retirement in September 2007. He served as President since 1983 and was appointed Chief Executive Officer in January 2007. Trendmaker Homes, Inc. was a Houston, Texas-based homebuilding and land development subsidiary of Weyerhaeuser Company. Mr. Hathorn has also held senior executive and financial positions with several public corporations and served as a director of Burnup & Sims Inc. from 1981 until 1997 and of Hartman Commercial Properties REIT, a publicly-traded real estate investment trust, from 2000 to 2005. Mr. Hathorn first served on the Company's Board of Directors from its inception in 1985 to September 1993 while also serving as a Burnup & Sims director and representative during the Company's formative years. He returned to our Board in June 1997 and has served as a director since that time. Mr. Hathorn's extensive expertise as a seasoned financial executive, his professional business acumen and his intimate knowledge of our business qualify him to serve on our Board.

BOARD LEADERSHIP STRUCTURE

The Board of Directors does not have a policy addressing whether the same person should serve as both the Chief Executive Officer and Chairman of the Board or if the roles should be separate but believes that it should have the

flexibility to make its determination based upon what it considers to be the appropriate leadership structure for the Company at the time. The Board further believes that having a single person serving as both Chief Executive Officer and Chairman of the Board, coupled with our use of individual chairmen for each of our Board committees, currently provides the best form of leadership for our Company. Accordingly, the Board has not deemed it necessary or appropriate to create the position of lead independent director, in that each Committee Chairman functions in the capacity akin to that of a lead director. Combining the Chairman and Chief Executive Officer roles fosters clear accountability, effective decision-making, alignment of our corporate strategies and has served the Company well for many years. As our Chief Executive Officer, Mr. Nick A. Caporella is and has been responsible for overseeing the operations of the Company and implementing the Company's corporate strategies. The Board believes that the breadth of Mr. Caporella's business experience, professional and successful track record in all of his undertakings in the Company, along with his position as founder and controlling shareholder of the Company, make him uniquely qualified to continue to preside over the entire Board, lead its strategies and discussions and set its agendas.

Board’s Role in Risk Oversight

While management is primarily responsible for the day-to-day assessment and risk management programs, the Board of Directors is responsible for oversight of enterprise-wide exposures, including strategic, operational, financial, legal and regulatory risks. The Board performs its oversight function both directly and indirectly through Board committees that are chaired by professionals with varied and extensive business experience. The Audit Committee assists the Board in evaluating financial risks and risks related to the Company’s financial reporting, internal controls and compliance with legal and regulatory requirements. The Compensation and Stock Option Committee assists the Board in evaluating risks associated with leadership assessment, management succession planning and our compensation philosophy and programs. In addition to committee reports, the Board receives regular presentations from senior management and senior department heads, which include presentations regarding the annual operating plan as well as long-term operational and strategic matters.

EXECUTIVE COMPENSATION AND OTHER INFORMATION

Compensation Discussion and Analysis

The following discussion and analysis is intended to provide an understanding of the Company’s compensation philosophy and policies and the actual compensation earned by each of our Executive Officers. It should be noted that neither Mr. Nick A. Caporella nor Mr. Bracken receives cash compensation from the Company. The services of both are provided to the Company by CMA and their cash compensation is based solely on and included within the management fee paid to CMA. (See “Management Services Agreement – Compensation” and “Certain Relationships and Related Party Transactions”.)

At the 2014 Annual Meeting, 86% of the shares voted by our shareholders were voted to approve, on an advisory basis, the compensation of our Executive Officers. We believe this vote supports our view that the Company’s compensation decisions and compensation philosophy and policy discussed below appropriately align the interests of our Executive Officers with the short and long-term goals of the Company. Also based on the advisory vote of our shareholders at the 2011 Annual Meeting, the Board determined that the Company will hold shareholder advisory votes on executive compensation every three years. The next shareholder advisory vote on executive compensation is scheduled to take place at the Annual Meeting of Shareholders to be held in 2017.

Compensation Philosophy

The objectives of the Company's compensation program are to (1) attract, motivate, develop and retain top quality executives who will increase long-term shareholder value and (2) deliver competitive total compensation packages based upon the achievement of both Company and individual performance goals. The Company expects its executives to balance the risks and related opportunities inherent in our industry and in the performance of his or her duties, and to adhere to the Company's philosophy and business principles in order to participate in any upside opportunity once actual performance is measured.

To achieve the above goals, the Compensation and Stock Option Committee has set forth a compensation program for its Executive Officers that includes the following elements:

- Base salary;
- Annual cash bonuses;
- Share-based compensation; and
- Retirement, health and other benefits.

In order to maintain a competitive compensation program for its Executive Officers, the Compensation and Stock Option Committee, on a semi-annual basis: (a) reviews compensation practices to assure fairness, relevance, support of the strategic goals of the Company and contribution of the executive to the creation of long-term shareholder value, (b) considers the relevant mix of compensation components and (c) implements a compensation plan that reasonably allocates a portion of each executive's total compensation to incentives and other forms of longer-term compensation linked to Company and individual performance, and the creation of shareholder value.

Factors Considered In Determining Compensation

The Compensation and Stock Option Committee reviews executive compensation levels for its Executive Officers on a semi-annual basis to ensure that they remain competitive within the beverage industry. The overall value of the compensation package for an Executive Officer is determined by the Compensation and Stock Option Committee in consultation with the Chief Executive Officer, other key officers and the Board. The factors considered by the Compensation and Stock Option Committee include those related to both the overall performance of the Company and the individual performance of the Executive Officer. Consideration is also given to comparable compensation data for individuals holding similarly responsible positions at other and peer group companies in determining appropriate compensation levels.

With respect to long-term incentive compensation to be awarded to Executive Officers, the Company maintains three equity-based plans: (a) the 1991 Omnibus Incentive Plan, (b) the Special Stock Option Plan and (c) the Key Employee Equity Partnership Program (each plan is discussed in more detail below).

The timing, amount and form of awards under these plans for each of the Executive Officers is made at the discretion of the Compensation and Stock Option Committee based on recommendations of the Chief Executive Officer. Any such awards are granted only upon the written approval of the Compensation and Stock Option Committee. No stock-based awards or other equity rights have been granted to Mr. Nick A. Caporella since the Company’s inception.

Elements of Executive Compensation

Base Salary

Base salary is used to attract and retain Executive Officers and is determined using comparisons with industry competitors and other relevant factors including the seniority of the individual, the functional role of the position, the level of the individual’s responsibility and the ability to replace the individual. Salaries for the Executive Officers are reviewed by the Compensation and Stock Option Committee, the Chief Executive Officer and the Board on a semi-annual basis. Changes to base salaries, if any, are affected primarily by individual performance.

Annual Cash Bonuses

Annual cash bonuses are intended to be a significant component of an Executive Officer's compensation package. The amount of annual bonus compensation to be awarded to the Executive Officers, if any, is determined by the Compensation and Stock Option Committee, upon recommendation by the Chief Executive Officer. While the Chief Executive Officer and the Compensation and Stock Option Committee consider the Company's overall performance and each individual's performance when determining the amount of bonus to award, there is no predefined written plan, acknowledged by the recipient, with respect to performance measures that obligates the Company to pay an annual cash bonus and the Compensation and Stock Option Committee retains absolute discretion to award bonuses and to determine the amount of such bonuses.

Share-Based Compensation (Long-Term Incentive Programs)

Share-based long-term incentive compensation is provided to Executive Officers through the award of stock options. The primary purpose of stock options is to provide Executive Officers and other employees with a personal and financial interest in the Company's success through stock ownership, thereby aligning their interests with those of our shareholders. The Compensation and Stock Option Committee believes that the value of stock options will reflect the Company's financial performance over the long-term. Because the Company's stock option programs require vesting periods before options may be exercised and an exercise price based on either the fair market value as of the date of grant or the amount of Common Stock held, the value of stock options and stock ownership increases when the market value of the Company's common shares increases over time.

Share-based awards made under the Company’s 1991 Omnibus Incentive Plan (the “Omnibus Plan”) typically consist of options to purchase Common Stock which vest over five years and have a term of ten years. Certain key executives of the Company also receive grants from time to time under the Company’s Special Stock Option Plan (the “Special Option Plan”). The vesting schedule and exercise price of these options are tied to the executive’s ownership levels of Common Stock. Generally, the terms of the Special Option Plan allows for the reduction in exercise price upon each vesting date of the option. The vesting schedule and exercise price reduction of such options may be accelerated at the discretion of the Compensation and Stock Option Committee. While the Compensation and Stock Option Committee considers the Company’s overall financial performance during the respective vesting periods, there is no predefined written plan with respect to financial measures that obligates the Company to such acceleration, and the Compensation and Stock Option Committee has not elected to accelerate the vesting or price reduction of any options held by Executive Officers during the past three fiscal years. The Company issues share-based awards with long-term vesting schedules designed to increase the level of the executive’s stock ownership, encourage long-term employment, promote adherence to the Company’s principles and philosophy and create long-term value for shareholders, while inducing corporate compatibility within the management team.

In addition, share-based compensation is awarded under the Company’s Key Employee Equity Partnership Program (the “KEEP Program”). The KEEP Program is designed to positively align interests between the Company’s executives and its shareholders beyond traditional option programs while, at the same time, stimulating and rewarding management for “partnering-up” with the Company to create shareholder value. The KEEP Program provides for granting stock options to key employees, officers and directors of the Company who invest their personal funds in Common Stock. Participants who purchase shares of Common Stock in the open market receive grants of stock options equal to 50% of the number of shares purchased up to a maximum of 6,000 shares purchased in any two-year period. Options under the KEEP Program are automatically forfeited upon the sale of shares originally acquired by the participant. The options are granted at an initial exercise price of 60% of the purchase price paid for the shares acquired and reduce to the par value of Common Stock at the end of the six-year vesting period.

The Company’s long-term incentive programs are generally intended to provide rewards to executives only if value is created for shareholders over time and the executive continues in the employ of the Company. The Compensation and Stock Option Committee believes that employees should have sufficient holdings of the Company’s Common Stock so that their decisions will appropriately foster sound judgment in the exercise of their duties. The Compensation and Stock Option Committee reviews with the Chief Executive Officer the recommended individual awards and evaluates the scope of responsibility, strategic and operational goals and individual contributions in making final awards under the Omnibus Incentive Plan and the Special Option Plan, and determines participants in the KEEP Program.

Options issued pursuant to the Special Option Plan and the KEEP Program after December 31, 2004 are considered deferred compensation arrangements under Section 409A of the Internal Revenue Code of 1986, as amended (the “Code”). Accordingly, option recipients must make a written election to exercise option grants on specified future dates to avoid being subject to additional income taxes, interest and withholding. The election is irrevocable, but may be subject to acceleration upon proper termination of employment, disability or in certain other limited circumstances, at the discretion of the Board of Directors. All Executive Officers holding options granted under these plans have made such an election.

With respect to share-based compensation, the Company recognizes stock compensation expense in accordance with FASB Accounting Standards Codification Topic 718 which requires public companies to measure the cost of employee services received in exchange for an award of equity instruments based on the grant date fair value of the award. The Company uses the Black-Scholes option-pricing model to determine the grant date fair value.

The Company ensures that stock option awards approved by the Compensation and Stock Option Committee will be granted subsequent to any planned release of material non-public information. The Company has not engaged in the backdating, cancellation or re-pricing of stock options awarded to its Executive Officers.

Retirement, Health and Other Benefits

The Company provides retirement, health and other benefits as an additional incentive to retain employees. The Company maintains a defined contribution 401(k) plan that allows employees to make plan contributions on a pre-tax basis and currently contributes an additional profit sharing contribution on behalf of each employee. Profit sharing contributions are allocated to all employees who meet certain minimum service requirements, based on a percentage of total compensation, which amount is subject to change from year to year. Although Executive Officers are eligible to participate in the 401(k) plan, they have been prevented from participating at the same level as non-executives, due to the rules under Section 401(a)(17) of the Code which dictate the application of an annual limitation on contributions.

We currently make available to our Executive Officers and all employees a comprehensive health, dental, life and disability insurance program. The health care insurance program offers a variety of coverage options, which may be selected at the employee’s discretion. The Company currently provides a basic term-life insurance policy to all employees and makes additional coverage available at the employee’s expense and discretion.

The Company does not provide any additional perquisites to Executive Officers, other than a car allowance, which is included in the Summary Compensation Table below. The total of all perquisites to any Executive Officer did not equal or exceed $10,000 for Fiscal 2016.

Employment, Change in Control and Severance Agreements

The Company does not typically enter into, and does not currently have, any formal employment, change in control, severance or other similar agreements with any Executive Officer. The Company’s stock option plans, however, provide that unvested options held by all employees will fully vest if a change of control (as defined in the plans) occurs or if options of an equivalent value are not provided in the event the Company is not the surviving entity of a merger or consolidation. Based on the difference between the closing stock price of the Company’s Common Stock on April 30, 2016 and the option exercise prices on that date, the values of unvested options held by our Executive Officers were: Joseph G. Caporella - $1,099,938; George R. Bracken - $538,695; and Gregory P. Cook - $132,999.

The Company may also, from time to time, pay severance to an employee, including an Executive Officer, based on, among other things, years of service, functional role or position and level of the individual’s responsibility and reasons for terminating his or her services. The Company believes in trust, loyalty and commitment from both the Company and the Executive Officers and that employment agreements are not necessary to achieve its goals and meet the needs of the Executive Officers. The Company believes that the fact that most of the executives of the Company have been with the Company for a long period of time supports this belief.

REPORT OF THE COMPENSATION AND STOCK OPTION COMMITTEE

The Compensation and Stock Option Committee has reviewed and discussed the foregoing Compensation Discussion and Analysis, required by Item 402(b) of Regulation S-K, with management of the Company. Based on this review and discussion, we recommended to the Board of Directors that the Compensation Discussion and Analysis be included in this Proxy Statement for the Company's 2016 Annual Meeting of Shareholders.

THE COMPENSATION AND STOCK OPTION COMMITTEE

Cecil D. Conlee (Chairman)

Samuel C. Hathorn, Jr. (Deputy Chairman)

Stanley M. Sheridan

11

MANAGEMENT SERVICES AGREEMENT – COMPENSATION

CMA, pursuant to a management agreement, provides the services of and compensates the Company's Chief Executive Officer, Chief Financial Officer and senior and other corporate personnel, who provide management, administrative and creative functions to the Company. Although management fees paid to CMA have been disclosed in "Certain Relationships and Related Party Transactions" since the inception of the management agreement in 1992, during 2009, the Commission requested that we modify the presentation of amounts paid to Mr. Nick A. Caporella and Mr. Bracken. In a comment letter dated February 9, 2009, the Commission staff requested that, due to Mr. Caporella's 100% ownership of CMA, the entire management fee paid to CMA be reflected as compensation to Mr. Caporella in the body of the Summary Compensation Table. As a result, we agreed (for reporting purposes) to include the management fee paid by the Company to CMA under the caption "All Other Compensation" with respect to Mr. Nick A. Caporella in the Summary Compensation Table. We believe this method of reporting constitutes an ultra-conservative and most probable misleading approach that could have the reader construe that these amounts are paid by the Company and/or CMA directly to him due to his ownership of CMA. These amounts paid by the Company to CMA, as reflected in the Summary Compensation Table, should not be interpreted as the actual amount of compensation paid to him by either the Company or CMA and are shown only to comply with the comment letter dated February 9, 2009. The cash compensation of Mr. Bracken, who serves as Principal Financial Officer of National Beverage Corp., is also paid by CMA and is included under the "All Other Compensation" caption in the Summary Compensation Table. (See "Certain Relationships and Related Party Transactions".)

12

SUMMARY COMPENSATION TABLE

The following table sets forth information concerning compensation awarded to, earned by or paid to our Executive Officers, and payments made to CMA, for services rendered during the past three fiscal years:

1 Mr. Nick A. Caporella, our Chairman of the Board and Chief Executive Officer, and Mr. George R. Bracken, our Executive Vice President-Finance, do not receive any cash compensation from the Company as their services are provided to us through CMA. As described above in “Compensation Discussion and Analysis” and “Management Services Agreement – Compensation” and below in “Certain Relationships and Related Party Transactions”, we pay an annual base management fee equal to one percent of our consolidated net sales for the services that CMA provides, which include, among other things, the services of Mr. Nick A. Caporella and Mr. Bracken, as well as senior and other corporate personnel who are not required to be included in the table above, and the supervision of the Company’s financial, legal, executive recruitment, internal audit and management information systems departments. The amounts set forth with respect to Mr. Nick A. Caporella under the caption “All Other Compensation” represent the total management fees paid by us to CMA (which is compliant with the conservative presentation requested by the Commission) for the respective fiscal years and should not be construed to be actual compensation paid by either the Company or CMA to Mr. Caporella. The amounts set forth with respect to Mr. Bracken under the caption “All Other Compensation” represent payments to him by CMA.

2 As prescribed by SEC regulations, amounts represent the grant date fair value for Special Option awards granted on August 27, 2014 computed in accordance with Accounting Standards Codification 718 based on the Black-Scholes option-pricing model. (See Note 8 to the Financial Statements included in the Company’s Annual Report on Form 10-K for additional information regarding the assumptions utilized.) Special Options generally vest over five to nine-year periods and accordingly the Company recognizes compensation expense with respect to these options over the projected vesting periods. The gain realized by the recipient, if any, upon exercise is dependent upon future events and therefore, the amount reflected on this table is not necessarily the amount that will be realized. Accordingly, the Company believes that this methodology does not fully reflect the periodic cost to the Company or the value to the recipient and therefore has provided additional GAAP based option expense information. (See footnote 3 below.)

[3] Amounts represent the annual compensation expense recognized for stock option awards computed in accordance with Generally Accepted Accounting Principles ("GAAP") pursuant to Accounting Standards Codification 718 based on the Black-Scholes option pricing model. (See Note 8 to the Financial Statements included in the Company's Annual Report on Form 10-K for additional information regarding the assumptions utilized.) Options held by our Executive Officers generally vest over five to nine-year periods and are expensed in accordance with GAAP. The Company believes that the annual compensation expense provides a more meaningful measure of the value of these options for any given fiscal year than the grant date fair value amount prescribed by SEC regulations and therefore has been included as supplementary information.

[4] The Company's Board and management believe that anomalies exist in the request to conform with SEC requirements and therefore have aligned this presentation to more appropriately recognize expense in accordance with GAAP and more clearly inform the reader. As stated in the Summary Compensation Table, the amounts under Mr. Nick A. Caporella's SEC compensation column are more clearly defined in footnote 1 of this section.

[5] Mr. Nick A. Caporella has not been awarded stock options, therefore, his total does not differ from the SEC prescribed total.

GRANTS OF PLAN-BASED AWARDS IN FISCAL 2016

There were no equity or non-equity incentive plan based awards to Executive Officers during Fiscal 2016.

OUTSTANDING EQUITY AWARDS AT END OF FISCAL 2015

The following table sets forth information about the number of outstanding equity awards held by our Executive Officers at April 30, 2016. No equity awards have been granted to Nick A. Caporella since the inception of the Company.

Name	Option Awards Number of Securities Underlying Unexercised Options (# Exercisable)	Number of Securities Underlying Unexercised Options (# Unexercisable)	Option Exercise Price ($)	Option Expiration Date
Joseph G. Caporella	24,168	13,832	5.68[1]	07/27/20
	2,800	17,200	15.81[1]	08/26/24
George R. Bracken	4,560	3,440	6.13[1]	07/27/20
	2,100	12,900	15.81[1]	08/26/24
Gregory P. Cook	3,000	—	11.35	05/04/20
	700	4,300	15.81[1]	08/26/24

1 Options granted under the Company’s Special Option Plan are exercisable for a ten-year period and vest in relatively equal amounts at approximately 16-month intervals. The exercise price can be reduced and the vesting schedule can be accelerated if the optionee purchases and maintains ownership of shares of Common Stock and the Company achieves performance objectives as determined by the Board. Based upon these factors, full vesting can occur from 64 to 104 months after issuance and the exercise price can range from 50% to 7% of the initial grant price if the options are held until the final vesting date.

OPTION EXERCISES AND STOCK VESTED IN FISCAL 2016

The following table sets forth all stock options exercised and the value received upon exercise by the Executive Officers during Fiscal 2016. There are no stock awards outstanding.

Name	Number of Shares Acquired on Exercise (#)	Value Realized on Exercise ($)[1]
Joseph G. Caporella	42,000	1,624,980
George R. Bracken	4,800	154,464
Gregory P. Cook	2,400	70,949

[1] The value realized on exercise was calculated by taking the difference between the fair market value per share on the date of the exercise less the option price, multiplied by the number of shares acquired.

EQUITY COMPENSATION PLAN INFORMATION

The following table sets forth information about shares of Common Stock that may be issued upon exercise of options and other stock-based awards under all of the Company's equity compensation plans as of April 30, 2016.

Plan Category	Number of Securities to be Issued upon Exercise of Outstanding Options, Warrants and Rights	Weighted Average Exercise Price of Outstanding Options, Warrants and Rights ($)	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in First Column)
Equity compensation plans approved by shareholders	405,650	12.67	2,686,647

Equity compensation plans not approved by shareholders[1]	13,	245	5.	45	115,	967
Total	418,	895	12.	44	2,802,	614

[1] Includes shares issuable for outstanding options and shares available for grant under the Company's KEEP Program.

DIRECTOR COMPENSATION

Officers of the Company who are also directors do not receive any fee or remuneration for services as members of the Board of Directors or of any Committee of the Board of Directors. Non-management directors receive a retainer fee of $40,000 per annum, a fee of $2,000 for each Board meeting attended, a fee of $1,500 for each Audit Committee meeting attended ($2,500 in the case of the Chairman) and a fee of $1,000 ($1,700 in the case of a committee Chairman) for each other committee meeting attended. Set forth below are the amounts paid to non-management directors in Fiscal 2016.

Name	**Fees Earned or Paid in Cash ($)**	**Grant Date Option Award Value ($)**	**All Other Compensation ($)**	**Total ($)[2]**
Cecil D. Conlee	54,600	54,572[1]	—	109, 172
Samuel C. Hathorn, Jr.	65,800	—	—	65,800
Stanley M. Sheridan	54,900	—	—	54,900

[1] As prescribed by SEC regulations, amount represents the aggregate grant date fair value for Special Options awarded during Fiscal 2016 computed in accordance with Accounting Standards Codification 718, based on the Black-Scholes option-pricing model. Compensation expense recognized for accounting purposes with respect to stock options held by directors during Fiscal 2016, computed in accordance with Accounting Standards Codification 718, is as follows: Mr. Conlee $42,382, Mr. Hathorn $28,018 and Mr. Sheridan $18,725. See footnotes 2 and 3 to the Summary Compensation Table for additional information.

[2] Totals, including compensation expense recognized for accounting purposes with respect to stock options held by directors, are as follows: Mr. Conlee $96,982, Mr. Hathorn $93,818 and Mr. Sheridan $73,625.

COMPENSATION COMMITTEE INTERLOCKS AND INSIDER PARTICIPATION

None

REPORT OF THE AUDIT COMMITTEE

The Audit Committee of the Board of Directors has furnished the following report:

Pursuant to its charter, the Audit Committee oversees the Company's financial reporting process on behalf of the Board of Directors. The Company's management has the primary responsibility for the financial statements and reporting process, including the Company's internal control systems. In fulfilling its oversight responsibilities, the Audit Committee reviewed and discussed with management the audited financial statements included in the Annual Report on Form 10-K for the fiscal year ended April 30, 2016. This review included a discussion of the quality and the acceptability of the accounting principles, the reasonableness of significant judgments and the clarity of disclosures in the financial statements.

The Audit Committee discussed with the Company's independent auditors, who are responsible for expressing an opinion on the conformity of the Company's audited financial statements with generally accepted accounting principles, all matters required to be discussed by Auditing Standards No. 16, "Communications with Audit Committees" issued by the Public Company Accounting Oversight Board ("PCAOB"). In addition, our independent auditors provided the Committee with the written disclosures and the letter required by the applicable requirements of the PCAOB relating to the independent auditor's communications with the Committee concerning independence.

The Audit Committee discussed with the independent auditors the overall plans for their audits, the results of their examinations, their evaluations of the Company's internal controls and the overall quality of the Company's financial reporting.

In reliance on the reviews and discussions referred to above, the Audit Committee recommended to the Board of Directors (and the Board has approved) that the audited financial statements be included in the Company's Annual Report on Form 10-K for the fiscal year ended April 30, 2016 for filing with the Commission.

THE AUDIT COMMITTEE

Samuel C. Hathorn, Jr. (Chairman)

Stanley M. Sheridan (Deputy Chairman)

Cecil D. Conlee

INDEPENDENT AUDITORS

The Company's financial statements for Fiscal 2016 and the year ended May 2, 2015 ("Fiscal 2015") were examined by RSM LLP ("RSM"), independent registered public accountants. Representatives of RSM are expected to be present at the Meeting to make a statement if they so desire and they are expected to be available to respond to appropriate questions.

Audit and Other Fees

For professional services rendered for the annual audit of the Company's consolidated financial statements and internal controls, review of its interim financial statements included in the Company's Form 10-Q and services that are normally provided in connection with statutory and regulatory filings, the Company was billed $419,000 for Fiscal 2016 and $435,000 for Fiscal 2015. Included in such amounts are fees associated with Sarbanes-Oxley Section 404 requirements of $197,000 for Fiscal 2016 and $207,000 for Fiscal 2015.

During Fiscal 2016 and 2015, RSM did not bill the Company for any tax consulting or other products or services. The Audit Committee pre-approves all audit and permitted non-audit fees before such service is rendered.

CERTAIN RELATIONSHIPS AND RELATED PARTY TRANSACTIONS

The Company is a party to a management agreement with CMA, a corporation owned by our Chairman and Chief Executive Officer. This agreement was originated in 1991 for the efficient use of management of two public companies at the time. In 1994, one of those public entities, through a merger, no longer was managed in this manner.

Under the terms of the management agreement, CMA provides, subject to the direction and supervision of the Board of Directors of the Company, (i) senior corporate functions (including supervision of the Company's financial, legal, executive recruitment, internal audit and management information systems departments) as well as the services of a Chief Executive Officer and Chief Financial Officer, and (ii) services in connection with acquisitions, dispositions and financings by the Company, including identifying and profiling acquisition candidates, negotiating and structuring potential transactions and arranging financing for any such transaction. CMA, through its personnel, also provides, to the extent possible, the stimulus and creativity to develop an innovative and dynamic persona for the Company, its products and corporate image. In order to fulfill its obligations under the management agreement, CMA employs numerous individuals, who, acting as a unit, provide management, administrative and creative functions for the Company. In connection with providing services under the management agreement, CMA is a twenty percent (20%) joint owner of an aircraft used by the Company. The management agreement provides that the Company will pay CMA an annual base fee equal to one percent of the consolidated net sales of the Company, and further provides that the Compensation and Stock Option Committee and the Board of Directors may from time to time award additional incentive compensation to CMA. The Board of Directors on numerous occasions contemplated incentive compensation and, while shareholder value increased to over $2.5 billion (or 6,000%) since the inception of this agreement, no incentive compensation has been paid. We incurred management fees to CMA of $7.0 million for Fiscal 2016, $6.5 million for Fiscal 2015, and $6.4 million for Fiscal 2014. The Company does not have written policies and procedures with respect to related party transactions, but the Company's practice has been that the services and performance of CMA are reviewed annually by the independent members of the Compensation and Stock Option Committee and the Board of Directors. During the course of such reviews, the independent directors on the Compensation and Stock Option Committee have, on numerous occasions, proposed that CMA be paid an incentive due to superior performance based on various criteria, including the favorable outcome of specific negotiations and the performance of the Company's Common Stock. However, no incentive compensation has been accepted by CMA and, as noted above, none has been paid since the inception of the management agreement.

On January 25, 2013, the Company sold 400,000 shares of Special Series D Preferred Stock (the "Series D Preferred"), par value $1.00 per share, for an aggregate amount of $20 million to 8100 Partners, LLC, a Florida limited liability company (the "LLC"). Members of the LLC include George R. Bracken, the Company's Principal Financial Officer, other members of management and a trust previously established by Mr. Nick A. Caporella. The Series D Preferred accrued cash dividends in an amount equal to 3% per year on a quarterly basis until April 30, 2014 and, thereafter, at an annual rate equal to 370 basis points above the 3-Month LIBOR on a quarterly basis. The Series D Preferred was a

non-voting class of stock and redeemable at the option of the Company beginning May 1, 2014 at $50 per share. The terms of the Series D Preferred were reviewed and approved by a Special Committee which consisted of the independent members of the Board. After serious consideration of a more typical financial arrangement, the Board of Directors felt that the cost and expediency of issuing the Series D Preferred were favorable to the conventional method and decided that this method was of greater benefit to the Company. On May 2, 2014, the Company redeemed 160,000 shares of Series D Preferred, representing 40% of the amount outstanding, for an aggregate price of $8 million plus accrued dividends. In conjunction with the partial redemption, the annual dividend rate on the outstanding Series D Preferred was reduced to 2.5% for the twelve-month period beginning May 1, 2014. On August 1, 2014, the Company redeemed 120,000 additional shares of the Series D Preferred for an aggregate price of $6 million plus accrued dividends. On May 1, 2015, the Company and the members of the LLC agreed to extend the 2.5% annual dividend rate on the outstanding 120,000 shares of Series D Preferred through April 30, 2016. On April 29, 2016, the Company redeemed the final remaining shares of Series D Preferred for an aggregate price of $6 million plus accrued dividends.

PROXY SOLICITATION

The accompanying proxy is solicited by and on behalf of the Board of Directors of the Company. Proxies may be solicited by personal interview, mail, email, telephone or facsimile. The Company will also request banks, brokers and other custodian nominees and fiduciaries to supply proxy material to the beneficial owners of the Company's Common Stock of whom they have knowledge, and the Company will reimburse them for their expense in so doing. Certain directors, officers and other employees of the Company may solicit proxies without additional remuneration. The entire cost of the solicitation will be borne by the Company

CONTACTING THE BOARD OF DIRECTORS

Shareholders who wish to communicate with the Board of Directors may do so by writing to Board of Directors, National Beverage Corp., P.O. Box 16720, Fort Lauderdale, Florida 33318. Such communications will be reviewed by the Secretary of the Company, who shall remove communications relating to solicitations, junk mail or correspondence relating to customer service issues. All other communications shall be forwarded to the Board of Directors or specific members of the Board as appropriate or as requested in the shareholder communication.

Any proposal of a shareholder intended to be presented at the Company's 2017 Annual Meeting of Shareholders must be received by the Company for inclusion in the Proxy Statement and form of proxy for that meeting no later than April 28, 2017. Additionally, the Company must receive notice of any shareholder proposal to be submitted at the 2017 Annual Meeting of Shareholders (but not required to be included in the Proxy Statement) by July 11, 2017, or such proposal will be considered untimely pursuant to Rule 14a-4 and 14a-5(e) of the Exchange Act and the persons named in the proxies solicited by management may exercise discretionary voting authority with respect to such proposal.

Our Restated Certificate of Incorporation contains an advance notice provision relating to shareholder nominations of directors at any meeting of the shareholders called for the election of directors. Under the Company's Restated Certificate of Incorporation, any nomination must (i) be received by our Secretary no earlier than 60 and no more than 90 days before the meeting by notice to the Secretary of the Company, provided, however, that if fewer than 70 days' notice of the meeting is given to stockholders, such written notice shall be received no later than 5:00 pm on the 10th calendar day following the first day following the day on which notice of the meeting was first mailed to stockholders and (ii) include certain information relevant to the shareholder and their nominee.

DISCRETIONARY VOTING OF PROXIES ON OTHER MATTERS

The Board of Directors does not now intend to bring before the Meeting any matters other than those disclosed in the Notice of Annual Meeting of Shareholders, and it does not know of any business which persons other than the Board of Directors intend to present at the Meeting. Should any other matter requiring a vote of the shareholders arise, the accompanying proxy form confers upon the person or persons entitled to vote the shares represented by any such proxy discretionary authority to vote the same in respect of any such other matter in accordance with their best judgment.

Please date, sign and return the proxy at your earliest convenience in the accompanying pre-addressed envelope (no postage is required for mailing in the United States) or vote electronically using the Internet or by telephone. A prompt return of your vote will be appreciated as it will save the expense of further mailings.

By Order of the Board of Directors,

Nick A. Caporella
Chairman of the Board
and Chief Executive Officer

August 26, 2016
Fort Lauderdale, Florida