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

FORM 10-Q

(Mark One)

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

For the quarterly period ended **March 31, 2017**

OR

TRANSITION REPORT UNDER SECTION 13 OF 15(d) OF THE EXCHANGE ACT OF 1934

From the transition period from to .

Commission File Number **001-35798**

KALOBIOS PHARMACEUTICALS, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation)

77-0557236
(IRS Employer
Identification No.)

1000 Marina Blvd., Suite 250, Brisbane, CA 94005
(Address of principal executive offices)
(Zip Code)

Registrant's telephone number, including area code: **(650) 243-3100**

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer

Accelerated filer

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

Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Section 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. Yes No

As of May 10, 2017, there were 14,977,397 shares of common stock of the issuer outstanding.



TABLE OF CONTENTS
KALOBIOS PHARMACEUTICALS, INC.
FORM 10-Q

| | <u>Page</u> |
|--|-------------|
| <u>PART I. FINANCIAL INFORMATION</u> | 3 |
| <u>Item 1. Financial Statements (unaudited)</u> | 3 |
| <u>Condensed Consolidated Balance Sheets as of March 31, 2017 and December 31, 2016</u> | 3 |
| <u>Condensed Consolidated Statements of Operations and Comprehensive Loss for the Three Months Ended March 31, 2017 and 2016</u> | 4 |
| <u>Condensed Consolidated Statements of Cash Flows for the Three Months Ended March 31, 2017 and 2016</u> | 5 |
| <u>Notes to Condensed Consolidated Financial Statements</u> | 6 |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 20 |
| <u>Item 4. Controls and Procedures</u> | 27 |
| <u>PART II. OTHER INFORMATION</u> | 28 |
| <u>Item 6. Exhibits</u> | 28 |
| <u>SIGNATURES</u> | 29 |

PART I. FINANCIAL INFORMATION**Item 1. Financial Statements**

KaloBios Pharmaceuticals, Inc.
Condensed Consolidated Balance Sheets
(in thousands, except share data)
(Unaudited)

| | <u>March 31,</u> <u>2017</u> | <u>December 31,</u> <u>2016</u> |
|---|---------------------------------|------------------------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 4,041 | \$ 2,906 |
| Prepaid expenses and other current assets | 1,706 | 1,643 |
| Total current assets | <u>5,747</u> | <u>4,549</u> |
| Property and equipment, net | 53 | 68 |
| Restricted cash | 101 | 101 |
| Other assets | 129 | - |
| Total assets | <u>\$ 6,030</u> | <u>\$ 4,718</u> |
| Liabilities and stockholders' deficit | | |
| Current liabilities: | | |
| Accounts payable | \$ 3,472 | \$ 4,072 |
| Accrued expenses | 1,387 | 736 |
| Term loans payable | 8,776 | 3,016 |
| Total current liabilities | <u>13,635</u> | <u>7,824</u> |
| Notes payable to vendors | 1,264 | 1,273 |
| Total liabilities | <u>14,899</u> | <u>9,097</u> |
| Stockholders' deficit: | | |
| Common stock, \$0.001 par value: 85,000,000 shares authorized at March 31, 2017 and December 31, 2016; 14,977,397 shares issued and outstanding at March 31, 2017 and December 31, 2016 | 15 | 15 |
| Additional paid-in capital | 237,274 | 236,216 |
| Accumulated deficit | <u>(246,158)</u> | <u>(240,610)</u> |
| Total stockholders' deficit | <u>(8,869)</u> | <u>(4,379)</u> |
| Total liabilities and stockholders' deficit | <u>\$ 6,030</u> | <u>\$ 4,718</u> |

See accompanying notes.

KaloBios Pharmaceuticals, Inc.
Condensed Consolidated Statements of Operations and Comprehensive Loss
(in thousands, except share and per share data)
(Unaudited)

| | Three Months Ended March 31, | |
|--|-------------------------------------|-------------------|
| | 2017 | 2016 |
| Operating expenses: | | |
| Research and development | \$ 2,669 | \$ 1,704 |
| General and administrative | 2,449 | 1,205 |
| Total operating expenses | <u>5,118</u> | <u>2,909</u> |
| Loss from operations | (5,118) | (2,909) |
| Other expense: | | |
| Interest expense | (291) | - |
| Other expense, net | (15) | - |
| Reorganization items, net | (124) | (2,517) |
| Net loss | <u>(5,548)</u> | <u>(5,426)</u> |
| Other comprehensive income | - | - |
| Comprehensive loss | <u>\$ (5,548)</u> | <u>\$ (5,426)</u> |
| Basic and diluted net loss per common share | <u>\$ (0.37)</u> | <u>\$ (1.22)</u> |
| Weighted average common shares outstanding used to calculate basic and diluted net loss per common share | <u>14,977,397</u> | <u>4,450,994</u> |

See accompanying notes.

KaloBios Pharmaceuticals, Inc.
Condensed Consolidated Statements of Cash Flows
(in thousands)

| | Three Months Ended March 31, | |
|--|-------------------------------------|-----------------|
| | 2017 | 2016 |
| Operating activities: | | |
| Net loss | \$ (5,548) | \$ (5,426) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation and amortization | 14 | 33 |
| Gain on lease termination | - | (227) |
| Noncash interest expense | 288 | - |
| Stock based compensation expense | 1,086 | 2 |
| Change in fair value of warrants issued in connection with acquisition of licenses | (28) | - |
| Changes in operating assets and liabilities: | | |
| Prepaid expenses and other assets | (191) | 538 |
| Accounts payable | (507) | 3,211 |
| Accrued Expenses | 651 | 107 |
| Liabilities subject to compromise | (130) | (235) |
| Net cash used in operating activities | <u>(4,365)</u> | <u>(1,997)</u> |
| Investing activities: | | |
| Changes in restricted cash | - | 143 |
| Net cash provided by investing activities | <u>-</u> | <u>143</u> |
| Financing activities: | | |
| Net proceeds from term loan | 5,500 | - |
| Net cash provided by financing activities | <u>5,500</u> | <u>-</u> |
| Net increase (decrease) in cash and cash equivalents | 1,135 | (1,854) |
| Cash and cash equivalents, beginning of period | 2,906 | 8,431 |
| Cash and cash equivalents, end of period | <u>\$ 4,041</u> | <u>\$ 6,577</u> |
| Supplemental cash flow disclosure: | | |
| Cash paid for interest | <u>\$ 2</u> | <u>\$ -</u> |
| Supplemental disclosure of non-cash investing and financing activities: | | |
| Change in fair value of warrants issued in connection with acquisition of licenses | <u>\$ (28)</u> | <u>\$ -</u> |

See accompanying notes.

KaloBios Pharmaceuticals, Inc.
Notes to Condensed Consolidated Financial Statements
(Unaudited)

1. Nature of Operations

Description of the Business

KaloBios Pharmaceuticals, Inc. (the “Company”) is a biopharmaceutical company focused on developing medicines for patients with neglected and rare diseases, with an ancillary focus on pediatric conditions, and on executing its Responsible Pricing Model in the commercialization of the Company’s product candidates that may be approved. The Company’s lead product candidate is benznidazole for the treatment of Chagas disease, a parasitic illness that can lead to long-term heart, intestinal and neurological problems. As more fully described in Note 10, the Company acquired certain worldwide rights to benznidazole on June 30, 2016 and the Company is focused on the development necessary to seek and obtain approval by the United States Food and Drug Administration (“FDA”) for benznidazole and the subsequent commercialization, if approved. After a meeting with FDA in December 2016, the Company believes benznidazole, as a treatment for Chagas disease, could qualify for priority review and potentially other FDA regulatory incentives, and to receive a Priority Review Voucher (“PRV”) if FDA approves the drug for marketing. FDA also confirmed at the December 2016 meeting, that it would be permissible for the Company to submit an Investigational New Drug (IND) application for benznidazole to FDA under the 505(b)(2) regulatory pathway, which it expects to do during the first half of 2017.

If the Company’s work to submit the New Drug Application (“NDA”) for benznidazole progresses on the timeline laid out above, management anticipate that FDA’s decision related to approval of NDA could occur before the end of 2018. As a result, the Company has begun preliminary commercial planning activities, including exploring monetization opportunities associated with potential receipt of a PRV, developing possible launch and commercialization strategies in the U.S. and seeking ways to generate revenue outside of the U.S. through partnerships.

The Company is also developing one of its proprietary monoclonal antibodies, lenzilumab (formerly known as KB003), for the treatment of chronic myelomonocytic leukemia (CMML), and potentially for the treatment of juvenile myelomonocytic leukemia (JMML), both of which are rare hematologic cancers with high unmet medical need. The Company is exploring partnering opportunities to enable development of another of its proprietary monoclonal antibodies, ifabotuzumab (formerly known as KB004), for the treatment of certain rare solid and hematologic cancers. With a focus on neglected, rare and orphan diseases, the Company believes that it has the opportunity to benefit from various regulatory incentives, such as orphan drug exclusivity, breakthrough therapy designation, fast track designation, accelerated approval, priority review and priority review vouchers, where available, that provide for certain periods of exclusivity, expedited review and/or other benefits.

The Company has undergone a significant transformation in the last year. As a result of challenges facing it at the time, on December 29, 2015, the Company filed a voluntary petition for bankruptcy protection under Chapter 11 of Title 11 of the U.S. Bankruptcy Code. On June 30, 2016, the Company’s Second Amended Plan of Reorganization, dated May 9, 2016, as amended (the “Plan”), became effective and the Company emerged from its Chapter 11 bankruptcy proceedings. Refer to Note 2 for additional details regarding the Company’s bankruptcy proceedings.

The Company was incorporated on March 15, 2000 in California and reincorporated as a Delaware corporation in September 2001.

Liquidity and Going Concern

The Company has incurred significant losses and had an accumulated deficit of \$246.2 million as of March 31, 2017. The Company has financed its operations primarily through the sale of equity securities, debt financings, interest income earned on cash and cash equivalents, grants and the payments received under its agreements with Novartis Pharma AG and Sanofi Pasteur S.A. (“Sanofi”). The Company completed its initial public offering (“IPO”) in February 2013. To date, none of the Company’s product candidates have been approved for sale and therefore the Company has not generated any revenue from product sales. Management expects operating losses to continue for the foreseeable future. As a result, the Company will continue to require additional capital through equity offerings, debt financing and/or payments under new or existing licensing or collaboration agreements. If sufficient funds are not available on acceptable terms when needed, the Company could be required to significantly reduce its operating expenses and delay, reduce the scope of, or eliminate one or more of its development programs. The Company’s ability to access capital when needed is not assured and, if not achieved on a timely basis, could materially harm its business, financial condition and results of operations. These conditions raise substantial doubt about the Company’s ability to continue as a going concern.

The Condensed Consolidated Financial Statements for the three months ended March 31, 2017 were prepared on the basis of a going concern, which contemplates that the Company will be able to realize assets and discharge liabilities in the normal course of business. The ability of the Company to meet its total liabilities of \$14.9 million at March 31, 2017 and to continue as a going concern is dependent upon the availability of future funding. The financial statements do not include any adjustments that might be necessary if the Company is unable to continue as a going concern.

Delisting of Common Stock

On January 13, 2016, the Company's common stock was suspended from the Nasdaq Global Market and began trading on the over-the-counter market under the KBIOQ symbol. On January 26, 2016, NASDAQ filed a Form 25 with the Securities and Exchange Commission to complete the delisting of the common stock, and the delisting was effective on February 5, 2016. On June 30, 2016, upon emergence from bankruptcy, the ticker symbol for the trading of the Company's common stock on the over-the-counter market reverted back to KBIO.

Basis of Presentation

The accompanying interim unaudited Condensed Consolidated Financial Statements have been prepared in accordance with U.S. generally accepted accounting principles ("U.S. GAAP") for interim financial information and on a basis consistent with the annual consolidated financial statements and include all adjustments necessary for the presentation of the Company's condensed consolidated financial position, results of operations and cash flows for the periods presented. The Condensed Consolidated Financial Statements include the accounts of the Company and its wholly owned subsidiaries. These financial statements have been prepared on a basis that assumes that the Company will continue as a going concern, which contemplates the realization of assets and the satisfaction of liabilities and commitments in the normal course of business. The December 31, 2016 Condensed Consolidated Balance Sheet was derived from the audited financial statements but does not include all disclosures required by U.S. GAAP. These interim financial results are not necessarily indicative of the results to be expected for the year ending December 31, 2017, or for any other future annual or interim period. The accompanying unaudited Condensed Consolidated Financial Statements should be read in conjunction with the audited consolidated financial statements and the related notes thereto included in the Company's 2016 Annual Report on Form 10-K (the "2016 Annual Report").

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the amounts and disclosures reported in the Condensed Consolidated Financial Statements and accompanying notes. Actual results could differ materially from those estimates. The Company believes judgment is involved in determining the valuation of the financing derivative, the fair value-based measurement of stock-based compensation, accruals and warrant valuations. The Company evaluates its estimates and assumptions as facts and circumstances dictate. As future events and their effects cannot be determined with precision, actual results could differ from these estimates and assumptions, and those differences could be material to the Condensed Consolidated Financial Statements.

2. Chapter 11 Filing

On December 29, 2015, the Company filed a voluntary petition for bankruptcy protection under Chapter 11 of the U.S. Bankruptcy Code. The filing was made in the United States Bankruptcy Court for the District of Delaware (the "Bankruptcy Court") (Case No. 15-12628 (LSS)).

In connection with financing efforts related to the Company's bankruptcy proceedings, on April 1, 2016, the Company entered into a Debtor-in-Possession Credit and Security Agreement (the "Credit Agreement") with a group of lenders (the "DIP Lenders"), pursuant to which the Company received \$3 million in funds for working capital, bankruptcy-related costs, costs related to its plan of reorganization, payment of certain fees to the DIP Lenders and other costs associated with the ordinary course of business. Funds received under the Credit Agreement bore interest at a rate of 12% and were due and payable upon the Effective Date of the Plan, as defined below. Payment due under the Credit Agreement was convertible into shares of the Company's common stock, with share amounts subject to calculation as provided in the Credit Agreement.

On April 1, 2016, the Company also entered into a Securities Purchase Agreement (the “SPA”) with the DIP Lenders. The SPA provided for the sale of the Company’s common stock, with share amounts subject to calculation as provided in the SPA, in respect of exit financing in the amount of \$11,000,000 to be received upon the Effective Date of the Plan, as defined below.

Plan of Reorganization

On May 9, 2016, the Company filed with the Bankruptcy Court the Plan and related amended disclosure statement pursuant to Chapter 11 of the Bankruptcy Code. On June 16, 2016, the Bankruptcy Court entered an order confirming the Plan.

The Plan became effective on June 30, 2016 (the “Effective Date”) and the Company emerged from its Chapter 11 bankruptcy proceedings. In connection with such emergence, the Company consummated the transactions and other items described below.

- Pursuant to the SPA and in repayment of its obligations under the Credit Agreement, the Company issued an aggregate of 9,497,515 shares of its common stock to the DIP Lenders.
- The Company became obligated to issue 327,608 shares of common stock to the plaintiffs in litigation related to the Company’s 2015 private financing transaction in accordance with the settlement stipulation discussed below. The Company recorded an obligation in stockholders’ equity to issue the related shares and recorded the related expense of approximately \$1.5 million as of December 31, 2015. As of March 31, 2017, all of the shares of common stock related to this settlement stipulation had been issued.
- The Company reserved 300,000 shares of common stock for issuance to the plaintiffs in class action litigation related to the events surrounding the Company’s former Chairman and Chief Executive Officer. The Company recorded an obligation in stockholders’ equity to issue the related shares and recorded the related expense of approximately \$1.3 million as of December 31, 2015. As of March 31, 2017, all of the shares related to this settlement stipulation had been issued.
- The Company became obligated to issue 3,750 shares of common stock to a former director in satisfaction of claims against the Company. The Company recorded an obligation in stockholders’ equity to issue the related shares and recorded the related expense of approximately \$16,000 as of December 31, 2015. As of March 31, 2017, all of the shares related to this settlement stipulation had been issued.
- The Company reserved for issuance shares of common stock in an amount as yet to be determined in connection with the settlement of certain other claims and interests as set forth in the Plan. As of March 31, 2017, management does not believe the issuance of additional common stock for any such claims is probable. As such, no accrual has been made in the Condensed Consolidated Financial Statements.
- The Company issued promissory notes in an aggregate principal amount of approximately \$1.2 million to certain vendors in accordance with the Plan. The notes are unsecured, bear interest at 10% per annum and are due and payable in full, including principal and accrued interest, on June 30, 2019. As of March 31, 2017, the Company has accrued \$90,000 of interest expense related to these promissory notes.
- The Company issued an aggregate of 323,155 shares of common stock to Cameron Durrant, Ronald Barliant, and David Moradi pursuant to an order by the Bankruptcy Court approving a one-time equity award for the Company’s Chief Executive Officer and two other directors. For the year ended December 31, 2016, the Company recorded a charge of \$1,451,000 representing the fair value of the shares issued and classified \$700,000 and \$751,000 as Reorganization items, net and General and administrative expenses, respectively.

Bankruptcy Claims Administration

On February 29, 2016, the Company filed its schedules of assets and liabilities and statement of financial affairs (the “Schedules”) with the Bankruptcy Court. The Bankruptcy Court entered an order setting April 1, 2016 as the deadline for filing proofs of claim for creditors other than governmental units and June 27, 2016 as the bar date for filing proofs of claim by governmental units (together, the “Bar Date”). The Bar Date is the date by which non-government claims against the Company relating to the period prior to the commencement of the Company’s Chapter 11 case were required to be filed if such claims were not listed in liquidated, non-contingent and undisputed amounts in the Schedules, or if the claimant disagrees with the amount, characterization or classification of its claim as reflected in the Schedules. Claims that are subject to the Bar Date and that were not filed on or prior to the Bar Date are barred from participating in any distribution that may be made under the Plan.

As of the Effective Date, approximately 195 proofs of claim were outstanding (including claims that were previously identified on the Schedules) totaling approximately \$32 million. Prior to the Bar Date, certain investors filed a class action claim in the amount of \$20 million in connection with events surrounding the Company's former Chairman and Chief Executive Officer. On June 15, 2016, a settlement stipulation related to the class action suit was approved under order of the Bankruptcy Court. The settlement stipulation required the Company to issue 300,000 shares of common stock and submit a payment of \$250,000 to the claimants. During the year ended December 31, 2016, the 300,000 shares were issued and the \$250,000 payment was made. See Note 11 for additional information on this matter and settlement.

Separately, a claim was filed by certain investors in the Company's 2015 private financing transaction totaling approximately \$6.9 million. On May 9, 2016, a settlement stipulation related to this suit was approved under order of the Bankruptcy Court. The settlement stipulation required the Company to issue 327,608 shares of common stock and submit a payment of \$250,000 to an escrow account on behalf of the claimants. During the year ended December 31, 2016, the 327,608 shares were issued and the \$250,000 payment was made. See Note 11 for additional information on this matter and settlement.

As of December 31, 2015, the Company recorded an obligation in Additional paid-in capital to issue the related shares totaling approximately \$2.8 million and recorded the cash liability of \$500,000 in Liabilities subject to compromise. Excluding these stipulated claims, all other proofs of claim amount to approximately \$5.1 million. As of December 31, 2015, the Company recorded a liability of approximately \$4.5 million, which represents its estimate of the amount expected to be allowed by the Bankruptcy Court, in Liabilities subject to compromise. In addition, the Company also had liabilities related to accrued compensation and deferred rent, totaling approximately \$0.4 million, included in Liabilities subject to compromise as of December 31, 2015.

As of June 30, 2016, the Company emerged from bankruptcy. The Company expects the amounts remaining in Liabilities subject to compromise as of the Effective Date to be paid in accordance with the Plan. Accordingly, as of March 31, 2017, Liabilities subject to compromise have been reduced to zero and reclassified according to their payment terms.

In March 2016, the Company entered into a termination agreement (the "Lease Termination Agreement") related to the lease of its prior facility in South San Francisco, California. The Lease Termination Agreement, approved by order of the Bankruptcy Court issued March 15, 2016, waived all damages related to early termination of the lease, relieved the Company of March rental expenses and set an effective termination date of March 31, 2016. In accordance with the termination of the lease, the Company wrote off remaining deferred rent liabilities of approximately \$312,000 and disposed of certain leasehold improvements and furniture and fixtures with a net book value of approximately \$85,000. The resulting gain of \$227,000 is included in Reorganization items, net, in the accompanying Condensed Consolidated Statement of Operations and Comprehensive Loss for the three months ended March 31, 2016. Concurrent with the termination of its prior lease, the Company entered into a lease agreement for a new office facility in Brisbane, California. The new lease commenced in April 2016 and was to expire in March 2017. On February 16, 2017, the Company amended the lease to extend the term of the lease for an additional period of eighteen months such that the lease will expire on September 30, 2018.

The reconciliation of certain proofs of claim filed against the Company in the Bankruptcy Case, including certain General Unsecured Claims, Convenience Class Claims and Other Subordinated Claims, is ongoing. As a result of its examination of the claims, the Company may ask the Bankruptcy Court to disallow, reduce, reclassify or otherwise adjudicate certain claims the Company believes are subject to objection or otherwise improper. Under the terms of the Plan, the Company had until December 27, 2016 to file additional objections to disputed claims, subject to the Company's right to seek an extension of this deadline from the Bankruptcy Court. By Order, dated February 6, 2017, the Bankruptcy Court extended the claims objection deadline to June 26, 2017. The Company may compromise certain claims with or without specific prior approval of the Bankruptcy Court as set forth in the Plan and may identify additional liabilities that will need to be recorded or reclassified to liabilities subject to compromise. The resolution of such claims could result in material adjustments to the Company's financial statements.

As of March 31, 2017, approximately \$837,000 in claims remain subject to review and reconciliation by the Company. The Company may file objections to these claims after it completes the reconciliation process. As of March 31, 2017, the Company has recorded \$81,000 and \$71,000 related to these claims in Accounts payable and Notes payable to vendors, respectively, which represents management's best estimate of claims to be allowed by the Bankruptcy Court.

Although the Bankruptcy Case remains open, other than with respect to certain matters relating to the implementation of the Plan, the administration of certain claims, or over which the Bankruptcy Court may have otherwise retained jurisdiction, the Company is no longer operating under the direct supervision of the Bankruptcy Court. The Company anticipates that the Bankruptcy Case will be closed following the completion of the claims reconciliation process.

Bankruptcy Related Financing Arrangements

On April 1, 2016, the Company entered into the Credit Agreement with Black Horse Capital Master Fund Ltd., as administrative agent and lender (“BHCMF” or “Agent”), Black Horse Capital LP, as a lender (“BHC”), Cheval Holdings, Ltd., as a lender (“Cheval”) and Nomis Bay LTD, as a lender (“Nomis” and, together with BCHMF, BHC and Cheval, the “Lenders”). The Credit Agreement provided for a debtor-in-possession credit facility in the original principal amount of \$3,000,000 (the “Term Loan”). The Credit Agreement provided that the Term Loan will be made by the Lenders at an original discount equal to \$191,000 (the “Upfront Fee”) and required the payment by the Company to the Lenders of a commitment fee equal to \$150,000 (the “Commitment Fee”). In accordance with the terms of the Credit Agreement, the Company used the proceeds of the Term Loan for working capital, bankruptcy-related costs, costs related to the Company’s plan of reorganization, the payment of certain fees and expenses owed to the Agent and the Lenders in connection with the Credit Agreement and other costs incurred in the ordinary course of business.

Pursuant to the terms of the Credit Agreement, the Term Loan bore interest at a rate per annum equal to 12.00%.

In accordance with the bidding procedures order entered by the Bankruptcy Court, the Term Loan and the SPA were together subject to competing, higher and better offers.

In connection with the Company’s obligations under the Credit Agreement, the Company executed in favor of the Agent an Intellectual Property Security Agreement, dated as of April 1, 2016 (the “IP Security Agreement”). Under the terms of the IP Security Agreement, the Company pledged all of its intellectual property to the Agent for the ratable benefit of the Lenders, as collateral for its obligations under the Credit Agreement.

The Credit Agreement provided that the outstanding principal balance of the Term Loan, plus accrued and unpaid interest, plus the Upfront Fee, plus the Commitment Fee and all other non-contingent obligations would mature on the earlier of an event of default under the Credit Agreement or the effective date of the Company’s plan of reorganization. The Maturity Date was deemed to occur simultaneously with the Effective Date and, accordingly, on June 30, 2016, 2,350,480 shares of common stock were issued to the Lenders in repayment of the Company’s debt obligations under the Credit Agreement, including 201,436 shares to BHC, 470,096 shares to BCHMF, 503,708 shares to Cheval, 940,192 shares to Nomis and 235,048 shares to Cortleigh Limited (“Cortleigh”). Pursuant to the terms of the Credit Agreement, the Company also paid \$406,000 to BHC in payment of its fees and expenses and \$285,000 to Nomis in payment of its fees and expenses.

The Company records discounts to convertible notes for the intrinsic value of conversion options embedded in debt instruments based upon the fair value of the underlying common stock at the commitment date of the note transaction exceeding the effective conversion price embedded in the note. The Company evaluated the Credit Agreement for beneficial conversion features and calculated a value of approximately \$484,000, all of which was expensed as of the Effective Date.

In conjunction with the Credit Agreement, during the year ended December 31, 2016, the Company incurred the following expenses which were charged to Reorganization items, net in 2016:

| (in thousands) | Year ended |
|---------------------------------------|-------------------|
| | December 31, 2016 |
| Upfront fee | \$ 191 |
| Commitment fee | 150 |
| Beneficial conversion feature | 484 |
| Legal fees | 802 |
| Total Credit Agreement expense | \$ 1,627 |

On April 1, 2016, the Company also entered into the SPA with the Lenders. The SPA provided for the sale to the Lenders on the closing date of an aggregate of 5,885,000 shares of common stock, subject to adjustment as provided in the SPA, in respect of exit financing in the amount of \$11,000,000 (the “Exit Financing”) plus an exit financing commitment fee of \$770,000 payable by the Company to the Lenders, plus payment to the Lenders of their fees and expenses incurred in connection with the Exit Financing and the SPA. Nomis subsequently assigned twenty percent (20%) of its interest in the shares of common stock to be purchased by Nomis under the SPA and the Credit Agreement to Cortleigh (collectively with the Lenders, the “Purchasers”).

The consummation of the transactions contemplated by the SPA were contingent on, among other things, the funding of the Term Loan, the approval of the Bankruptcy Court of the Company's plan of reorganization, and the simultaneous closing of the Company's transaction with Savant. In addition, the closing of the transactions under the SPA were contingent upon the board of directors of the Company, upon the effectiveness of the confirmed plan of reorganization, consisting of (i) one director to be designated by Nomis; (ii) one director to be jointly designated by BHC, BHCF, and Cheval; (iii) the Chief Executive Officer of the Company to be designated jointly and unanimously by the Lenders; and (iv) two independent directors to be designated jointly and unanimously by the Lenders.

The issuance of the shares contemplated by the SPA was consummated on the Effective Date, and the Company issued to the Purchasers an aggregate of 7,147,035 shares of common stock for an aggregate purchase price of \$11,000,000, including 612,501 shares to BHC, 1,429,407 shares to BHCF, 1,531,610 shares to Cheval, 2,858,814 shares to Nomis and 714,703 shares to Cortleigh. Pursuant to the terms of the SPA, the Company paid \$427,000 to BHC in payment of its fees and expenses and \$304,000 to Nomis in payment of its fees and expenses.

Under the terms of the SPA, the Company was required to use commercially reasonable efforts to cause a registration statement registering the resale by the Purchasers of the shares issuable under the SPA to be declared effective by the SEC no later than December 27, 2016. The Company was obligated to keep the registration statement effective until all of the shares issued pursuant to the SPA are eligible for resale by the Purchasers without volume restrictions under an exemption from registration under the Securities Act. If the registration statement has not been declared effective by December 27, 2016 and any of the shares issued pursuant to the SPA are not eligible to be sold under Rule 144, then during each subsequent thirty day period (or portion thereof) until the registration statement is declared effective, the Company agrees to issue additional shares of common stock to the Purchasers in an amount equivalent to 10.0% of the shares originally purchased under the SPA that are then held by the Purchasers. On October 28, 2016, the SPA was amended to require the Company to file a registration statement by January 10, 2017 with effectiveness to be no later than March 31, 2017. On December 19, 2016, the SPA was amended again to require the Company to file a registration statement by March 17, 2017 with effectiveness to be no later than June 20, 2017.

The Company timely filed a registration statement on Form S-1 on March 17, 2017 and is using commercially reasonable efforts to obtain effectiveness within the required timeframe.

Governance Arrangements

On the Effective Date, the Company and Martin Shkreli, the Company's former Chief Executive Officer, former Chairman and former controlling stockholder, entered into a Corporate Governance Agreement (the "Governance Agreement"), which provides for certain terms and conditions regarding the acquisition, disposition, holding and voting of securities of the Company by Mr. Shkreli. The Governance Agreement applies to all common stock owned by Mr. Shkreli or affiliates he controls.

Under the terms of the Governance Agreement, for 180 days following the Effective Date, Mr. Shkreli could not sell his shares of common stock at a price per share that was less than the greater of (x) \$2.50 and (y) a 10% discount to the prior two week volume-weighted average price (the "Market Discount Price"). In addition, for 180 days following the 61st day after the Effective Date, the Company had a right to purchase any or all of Mr. Shkreli's shares at a purchase price per share equal to the Market Discount Price. For a limited time, the Company also had a right of first refusal to purchase shares that Mr. Shkreli proposed to sell. Mr. Shkreli was also prohibited from transferring any shares to his affiliates or associates unless such transferee agreed to be subject to the terms of the Governance Agreement. Transfers of shares by Mr. Shkreli not made in compliance with the Governance Agreement would be null and void.

Under the terms of the Governance Agreement, Mr. Shkreli will not have any right to nominate directors to the Board of Directors of the Company and agreed in connection with any stockholder vote to vote his shares in proportion to the votes of the Company's public stockholders. The Governance Agreement also prohibits Mr. Shkreli or his affiliates for a period of 24 months after the date of the Governance Agreement, from, among other things:

- purchasing any stock or assets of the Company;
- participating in any proposal for any merger, tender offer or other business combination, or similar extraordinary transaction involving the Company or any of its subsidiaries;
- seeking to control or influence the management, the Company's Board or the policies of the Company; or

submitting any proposal to be considered by the stockholders of the Company.

In addition, any material transaction between Mr. Shkreli or his associates and the Company, or relating to the Governance Agreement, cannot be taken without the prior approval of the Company's Board.

The Governance Agreement provides for a mutual release between the Company and Mr. Shkreli of all claims and liabilities existing as of the date of execution.

On August 25 and August 26, 2016, Mr. Shkreli sold all of his shares of the Company to third party investors in private transactions.

Board Changes

On the Effective Date, in accordance with the Plan, Cameron Durrant, current Chief Executive Officer of the Company, as joint designee of BHCMF, BHC and Cheval (collectively, the "Black Horse Entities") and Nomis, continued as a director, Ronald Barliant, current member of the Board, continued as a director as the designee of the Black Horse Entities, Dale Chappell became a director as a designee of Nomis, and Timothy Morris and Ezra Friedberg became directors as joint designees of the Black Horse Entities and Nomis.

Financial Reporting in Reorganization

The Company applied Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 852, *Reorganizations*, which is applicable to companies under bankruptcy protection, and requires amendments to the presentation of key financial statement line items. It requires that the financial statements for periods subsequent to the Chapter 11 filing distinguish transactions and events that are directly associated with the reorganization from the ongoing operations of the business. Revenues, expenses, realized gains and losses, and provisions for losses that can be directly associated with the reorganization and restructuring of the business must be reported separately as reorganization items in the Condensed Consolidated Statements of Operations and Comprehensive Loss. The balance sheet must distinguish pre-petition liabilities subject to compromise from both those pre-petition liabilities that are not subject to compromise and from post-petition liabilities. Liabilities that may be subject to a plan of reorganization must be reported at the amounts expected to be allowed in the Company's Chapter 11 case, even if they may be settled for lesser amounts as a result of the plan of reorganization or negotiations with creditors.

As of December 31, 2015, the Company had approximately \$5.4 million recorded as Liabilities subject to compromise. In conjunction with the Company's exit from bankruptcy, the Company reclassified remaining Liabilities subject to compromise as of June 30, 2016 totaling approximately \$2.8 million, \$0.8 million and \$1.2 million to Accounts payable, Accrued expenses and Notes payable to vendors, respectively. For the year ended December 31, 2016, the Company paid approximately \$3.4 million related to Liabilities subject to compromise, issued \$1.2 million in promissory notes to vendors and wrote off approximately \$0.3 million in deferred rent liabilities related to its lease termination and reversed approximately \$0.1 million in accrued expenses related to a claim that has been denied by the court, which as discussed above, were previously included in Liabilities subject to compromise. For the three months ended March 31, 2017, the Company wrote off approximately \$0.2 million in claims that had been reduced or for which a settlement had been reached at a lower amount than what had been previously accrued. As of March 31, 2017, approximately \$0.2 million and \$1.2 million remain in Accounts payable and Notes payable to vendors, respectively. Remaining amounts will be paid based on terms of the Plan.

For the three months ended March 31, 2017 and 2016, Reorganization items, net consisted of the following charges:

| (in thousands) | Three months ended March 31, 2017 | Three months ended March 31, 2016 |
|--|--|--|
| Legal fees | \$ 112 | \$ 2,516 |
| Professional fees | 12 | 228 |
| Gain on lease termination | - | (227) |
| Total reorganization items, net | \$ 124 | \$ 2,517 |

Cash payments for reorganization items totaled \$354,000 and \$56,000 for the three months ended March 31, 2017 and 2016, respectively.

3. Summary of Significant Accounting Policies

There have been no material changes in the Company's significant accounting policies to those previously disclosed in the 2016 Annual Report.

4. Potentially Dilutive Securities

The Company's potential dilutive securities, which include stock options, restricted stock units and warrants, have been excluded from the computation of diluted net loss per common share as the effect of including those securities would be to reduce the net loss per common share and be antidilutive. Therefore, the denominator used to calculate both basic and diluted net loss per common share is the same in each period presented.

The following outstanding potentially dilutive securities have been excluded from the computations of diluted net loss per common share:

| | As of March 31, | |
|-----------------------------------|------------------------|----------------|
| | 2017 | 2016 |
| Options to purchase common stock | 2,432,843 | 397,988 |
| Restricted stock units | — | 3,750 |
| Warrants to purchase common stock | 356,193 | 131,193 |
| | <u>2,789,036</u> | <u>532,931</u> |

5. Investments

At March 31, 2017, the amortized cost and fair value of investments, with gross unrealized gains and losses, were as follows:

| (in thousands) | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|----------------------------|---------------------------|---------------------------------------|--|-------------------|
| Money market funds | \$ 101 | \$ — | \$ — | \$ 101 |
| Total investments | <u>\$ 101</u> | <u>\$ —</u> | <u>\$ —</u> | <u>\$ 101</u> |
| Reported as: | | | | |
| Cash and cash equivalents | | | | \$ — |
| Restricted cash, long-term | | | | 101 |
| Total investments | | | | <u>\$ 101</u> |

At December 31, 2016, the amortized cost and fair value of investments, with gross unrealized gains and losses, were as follows:

| (in thousands) | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|----------------------------|---------------------------|---------------------------------------|--|-------------------|
| Money market funds | \$ 101 | \$ — | \$ — | \$ 101 |
| Total investments | <u>\$ 101</u> | <u>\$ —</u> | <u>\$ —</u> | <u>\$ 101</u> |
| Reported as: | | | | |
| Cash and cash equivalents | | | | \$ — |
| Restricted cash, long-term | | | | 101 |
| Total investments | | | | <u>\$ 101</u> |

6. Fair Value of Financial Instruments

Cash, accounts payable and accrued liabilities are carried at cost, which approximates fair value given their short-term nature. Marketable securities and cash equivalents are carried at fair value.

The fair value of financial instruments reflects the amounts that would be received upon the sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (exit price). The fair value hierarchy is based on three levels of inputs that may be used to measure fair value, of which the first two are considered observable, and the third is considered unobservable, as follows:

Level 1 — Quoted prices in active markets for identical assets or liabilities.

Level 2 — Inputs other than those included in Level 1 that are directly or indirectly observable, such as quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 — Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The Company measures the fair value of financial assets and liabilities using the highest level of inputs that are reasonably available as of the measurement date. The following tables summarize the fair value of financial assets that are measured at fair value and the classification by level of input within the fair value hierarchy:

| (in thousands) | Fair Value Measurements as of | | | |
|-------------------------------------|-------------------------------|---------|---------|--------|
| | March 31, 2017 | | | |
| | Level 1 | Level 2 | Level 3 | Total |
| Investments: | | | | |
| Money market funds | \$ 101 | \$ — | \$ — | \$ 101 |
| Total assets measured at fair value | \$ 101 | \$ — | \$ — | \$ 101 |

| (in thousands) | Fair Value Measurements as of | | | |
|-------------------------------------|-------------------------------|---------|---------|--------|
| | December 31, 2016 | | | |
| | Level 1 | Level 2 | Level 3 | Total |
| Investments: | | | | |
| Money market funds | \$ 101 | \$ — | \$ — | \$ 101 |
| Total assets measured at fair value | \$ 101 | \$ — | \$ — | \$ 101 |

7. Notes Payable

Notes Payable to Vendors

On June 30, 2016, the Company issued promissory notes in an aggregate principal amount of approximately \$1.2 million to certain claimants in accordance with the Plan. The notes are unsecured, bear interest at 10% per annum and are due and payable in full, including principal and accrued interest on June 30, 2019. As of March 31, 2017, the Company has accrued a total of \$90,000 of interest expense related to these promissory notes in the accompanying Condensed Consolidated Balance Sheet with a charge to Interest expense of \$30,000 for the three months ending March 31, 2017 in the accompanying Statements of Operations and Comprehensive Loss.

December 2016 Term Loan

On December 21, 2016, the Company entered into a Credit and Security Agreement (the "Term Loan Credit Agreement") with BHCMF, as administrative agent and lender BHC, as a lender, Cheval, as a lender, and Nomis, as a lender (collectively, the "Term Loan Lenders"). The Term Loan Credit Agreement provides for a credit facility in the original principal amount of \$3,315,000, provides an original discount equal to \$265,000 (the "Upfront Fee") and requires the payment by the Company to the Term Loan Lenders of a commitment fee equal to \$153,000. In accordance with the terms of the Term Loan Credit Agreement, the Company will use the proceeds of the term loan (the "December 2016 Term Loan") for general working capital, the payment of certain fees and expenses owed to BHCMF and the Term Loan Lenders and other costs incurred in the ordinary course of business. Dr. Chappell, one of the Company's directors, is an affiliate of each of BHCMF, BHC and Cheval.

The Term Loans (as defined below) bear interest at 9.00% and are subject to certain customary representations, warranties and covenants, as set forth in the Term Loan Credit Agreement.

The outstanding principal balance of the Term Loans, plus accrued interest and fees, are due on the earlier of acceleration after an event of default under the Term Loan Credit Agreement, or October 31, 2017. However, to the extent the Company raises capital through any SEC-registered stock offering, 50% of such offering's proceeds (net of costs) must be used to pay down the Term Loans.

Upon the occurrence of any event of default set forth in the Term Loan Credit Agreement, BHCMF has the option of terminating the Term Loan Credit Agreement and declaring all of the Company's obligations immediately payable. The occurrence of an event of default will cause the Term Loans to bear interest at a rate per annum equal to 14.00%.

The Company's obligations under the Term Loan Credit Agreement are secured by a first priority interest in all of the Company's real and personal property, subject only to certain carve outs and permitted liens, as set forth in the agreement.

The Company recorded the original principal amount of the December 2016 Term Loan reduced by the Upfront Fee and costs incurred in putting the loan in place for a net principal amount of \$2,993,000.

As of March 31, 2017, the Company has accrued a total of \$234,000 of interest expense, consisting of \$83,000 interest and loan cost accretion of \$151,000 and has recorded such against the principal balance resulting in a loan balance of \$3,227,000 in the accompanying Condensed Consolidated Balance Sheet with a charge to Interest expense of \$30,000 for the three months ending March 31, 2017 in the accompanying Condensed Statements of Operations and Comprehensive Loss.

March 2017 Term Loan

On March 21, 2017, the Company entered into an amendment (the "Amendment") to the Term Loan Credit Agreement to obtain an additional term loan (the "March 2017 Term Loan" and, together with the December 2016 Term Loan, the "Term Loans") in the original principal amount of \$5,978,000 less an upfront fee equal to \$478,000 (the "Additional Upfront Fee"), and requires the payment by the Company to the Term Loan Lenders of a commitment fee equal to \$275,000, bringing the total original principal amount of the Term Loans to \$9,293,000. In accordance with the terms of the Term Loan Credit Agreement, the Company will use the proceeds from the additional loan for general working capital, the payment of certain fees and expenses owed to BHCMF and the Term Loan Lenders in connection with the Term Loan Credit Agreement and other costs incurred in the ordinary course of business. Aside from the increase in the principal amount extended, the Amendment did not modify any of the terms under the Term Loan Credit Agreement, all of which will be applicable to the March 2017 Term Loan extended to the Company by the Lenders.

The Company recorded the original principal amount of the additional loan reduced by the Additional Upfront Fee and costs incurred in putting the March 2017 Term Loan in place for a net principal amount of \$5,500,000.

As of March 31, 2017, the Company has accrued a total of \$49,000 of interest expense, consisting of \$15,000 interest and loan cost accretion of \$34,000 and has recorded such against the principal balance resulting in a loan balance of \$5,549,000 in the accompanying Condensed Consolidated Balance Sheet with a charge to Interest expense of \$49,000 for the three months ending March 31, 2017 in the accompanying Condensed Statements of Operations and Comprehensive Loss.

8. Commitments and Contingencies

Contractual Obligations and Commitments

As of March 31, 2017, there were no material changes to the Company's contractual obligations from those set forth in the 2016 Annual Report.

Guarantees and Indemnifications

The Company has certain agreements with service providers with which it does business that contain indemnification provisions pursuant to which the Company typically agrees to indemnify the party against certain types of third-party claims. The Company accrues for known indemnification issues when a loss is probable and can be reasonably estimated. The Company would also accrue for estimated incurred but unidentified indemnification issues based on historical activity. As the Company has not incurred any indemnification losses to date, there were no accruals for or expenses related to indemnification issues for any period presented.

9. Share Based Compensation

2012 Equity Incentive Plan

Under the Company's 2012 Equity Incentive Plan, the Company may grant shares, stock units, stock appreciation rights, performance cash awards and/or options to employees, directors, consultants, and other service providers. For options, the per share exercise price may not be less than the fair market value of a Company common share on the date of grant. Awards generally vest and become exercisable over three to four years and expire 10 years from the date of grant. Options generally become exercisable as they vest following the date of grant.

On September 13, 2016, the Board of Directors of the Company approved an amendment to the Company's 2012 Equity Incentive Plan to increase the number of shares of the Company's common stock available for issuance under the Plan by 3,000,000 shares and to increase the annual maximum aggregate number of shares subject to stock option awards that may be granted to any one person under the Plan from 125,000 to 1,100,000.

A summary of stock option activity for the three months ended March 31, 2017 under all of the Company's options plans is as follows:

| | Options | Weighted Average Exercise Price |
|----------------------------------|------------------|--|
| Outstanding at December 31, 2016 | 1,835,835 | \$ 4.15 |
| Granted | 615,000 | 2.92 |
| Exercised | — | — |
| Cancelled (forfeited) | (17,905) | 3.29 |
| Cancelled (expired) | (87) | 4.24 |
| Outstanding at March 31, 2017 | <u>2,432,843</u> | <u>\$ 3.85</u> |

The weighted average fair value of options granted during the three months ended March 31, 2017 was \$1.80 per share.

The Company valued the options granted using the Black-Scholes options pricing model and the following weighted-average assumption terms for the three months ended March 31, 2017:

| | Three Months Ended March 31, 2017 |
|---------------------|--------------------------------------|
| Exercise price | \$ 2.92 |
| Market value | \$ 2.92 |
| Risk-free rate | 1.93% to 2.09%% |
| Expected term | 5.0 to 6.0 years |
| Expected volatility | 83.2% to 87.9% |
| Dividend yield | - |

Stock-Based Compensation

The Company recorded stock-based compensation expense in the Condensed Consolidated Statements of Operations and Comprehensive Loss as follows:

| (in thousands) | Three Months Ended March 31, | |
|----------------------------|---------------------------------|-------------|
| | 2017 | 2016 |
| General and administrative | \$ 923 | \$ 1 |
| Research and development | 163 | 1 |
| | <u>\$ 1,086</u> | <u>\$ 2</u> |

At March 31, 2017, the Company had \$3.2 million of total unrecognized stock-based compensation expense, net of estimated forfeitures, related to outstanding stock options that will be recognized over a weighted-average period of 2.3 years.

10. Savant Arrangements

On February 29, 2016, the Company entered into a binding letter of intent (the “LOI”) with Savant Neglected Diseases, LLC (“Savant”). The LOI provided that the Company would acquire certain worldwide rights relating to benznidazole (the “Compound”) from Savant. Under the LOI, the Company made a non-refundable deposit to Savant of \$500,000, which was credited towards the Initial Payment (as defined below), and agreed to make monthly payments to Savant equal to \$87,500 for development services performed by Savant relating to the Compound.

The LOI provided that in consideration for the assets to be acquired, the Company would provide consideration to Savant, including:

- \$3,000,000 (the “Initial Payment”) payable as soon as practicable but in no event later than the Company emerging from its Chapter 11 bankruptcy pursuant to a plan of reorganization (the “Bankruptcy Exit”);
- a five-year warrant from the date of the Bankruptcy Exit to purchase up to 200,000 shares of common stock at a per share price of \$2.25, exercisable for 25% of the shares immediately and exercisable for the remaining shares upon reaching certain milestones related to regulatory approval of the Compound; and
- certain additional payments to be further specified in the definitive agreements.

On the Effective Date, as authorized by the Plan and the Confirmation Order, the Company and Savant entered into an Agreement for the Manufacture, Development and Commercialization of Benznidazole for Human Use (the “MDC Agreement”), pursuant to which the Company acquired certain worldwide rights relating to the Compound. The MDC Agreement consummates the transactions contemplated by the LOI.

Under the terms of the MDC Agreement, the Company acquired certain regulatory and non-intellectual property assets relating to the Compound and any product containing the Compound and an exclusive license of certain intellectual property assets related to the Compound. Savant will retain the right to use the licensed intellectual property for veterinary uses. The MDC Agreement provides that the Company and Savant will jointly conduct research and development activities with respect to the Compound, while the Company will be solely responsible for commercializing the Compound. The Company will fund the development program for the Compound and will reimburse Savant for its development program costs.

As required by the MDC Agreement, on the Effective Date, the Company made payments to Savant totaling \$2,687,500, consisting of the remaining portion of the Initial Payment less the deposit in the amount of \$2,500,000, an initial monthly Joint Development Program Cost payment of \$87,500, and reimbursement of Savant’s legal fees capped at \$100,000. The MDC Agreement provides for milestone payments, including payments related to U.S. and foreign regulatory submissions of up to \$21 million and certain other contingent payments. Additionally, the Company will pay Savant royalties in the mid-teens on net sales of any benznidazole product on a product-by-product and country-by-country basis, which royalty will be reduced to the high single digits in the United States if a priority review voucher is not granted subsequent to regulatory approval of any benznidazole product. The MDC Agreement also provides that Savant is entitled to a portion of the amount the Company receives upon the sale, if any, of a PRV relating to the Compound.

In addition, on the Effective Date the Company and Savant also entered into a Security Agreement (the “Security Agreement”), pursuant to which the Company granted Savant a continuing senior security interest in the assets and rights acquired by the Company pursuant to the MDC Agreement and certain future assets developed from those acquired assets.

On the Effective Date, the Company issued to Savant a five year warrant (the “Warrant”) to purchase 200,000 shares of the Company’s Common Stock, at an exercise price of \$2.25 per share, subject to adjustment. The Warrant is exercisable for 25% of the shares immediately and exercisable for the remaining shares upon reaching certain regulatory related milestones. In addition, pursuant to the MDC Agreement, the Company has granted Savant certain “piggyback” registration rights for the shares issuable under the Warrant.

The Company determined the fair value of the Warrant to be approximately \$670,000. During the course of 2016, the Company reevaluated the performance conditions and expected vesting of the Warrant at the end of each quarter and recorded expense of approximately \$361,000 during the year ended December 31, 2016 in Research and development expenses.

The Company reevaluated the performance conditions and expected vesting of the Warrant as of March 31, 2017 and recorded a reduction in expense of approximately \$28,000 during the three months ended March 31, 2017 due to a decline in the fair value, which reduction is included in Research and development expenses in the accompanying Condensed Consolidated Statement of Operations and Comprehensive Loss. The Company will continue to reevaluate the performance conditions and expected vesting of the Warrant on a quarterly basis until all performance conditions have been met.

Before a compound receives regulatory approval, the Company records upfront and milestone payments made to third parties under licensing arrangements as expense. Upfront payments are recorded when incurred and milestone payments are recorded when the specific milestone has been achieved.

The Company determined that the acquisition of the Compound should be treated as a purchase of in-process research and development. Accordingly, during the year ended December 31, 2016, the Company recorded \$3,250,000, which includes an additional \$250,000 payment made in 2015 to Savant, as Research and development expense. In addition, during the year ended December 31, 2016, the Company recorded \$262,500 in connection with the Joint Development Program and recorded \$100,000 in legal fee reimbursement as Research and development expense.

11. Litigation

Bankruptcy Proceeding

The Company filed for protection under Chapter 11 of Title 11 of the United States Bankruptcy Code on December 29, 2015. See Note 2 for additional information related to the bankruptcy.

Securities Class Action Litigation

On December 18, 2015, a putative class action lawsuit (captioned *Li v. KaloBios Pharmaceuticals, Inc. et al.*, 5:15-cv-05841-EJD) was filed against the Company in the United States District Court for the Northern District of California (the “Class Action Court”), alleging violations of the federal securities laws by the Company, Herb Cross and Martin Shkreli, the Company’s former Chairman and Chief Executive Officer. On December 23, 2015, a putative class action lawsuit was filed against the Company in the Class Action Court (captioned *Sciabacucchi v. KaloBios Pharmaceuticals, Inc. et al.*, 3:15-cv-05992-CRB), similarly alleging violations of the federal securities laws by the Company and Mr. Shkreli. On December 31, 2015, a putative class action lawsuit was filed against the Company in the Class Action Court (captioned *Isensee v. KaloBios Pharmaceuticals, Inc. et al.*, Case No. 15-cv-06331-EJD) also alleging violation of the federal securities laws by the Company, a former officer and Mr. Shkreli. On April 18, 2016, an amended complaint was filed in the *Isensee* suit, adding Herb Cross and Ronald Martell as defendants. On April 28, 2016, the Class Action Court consolidated these cases (the “Securities Class Action Litigation”) and appointed certain plaintiffs as the lead plaintiffs. The lead plaintiffs in the Securities Class Action Litigation were seeking damages of \$20.0 million on behalf of all the affected members of the class represented in the Securities Class Action Litigation, (the “Securities Class Action Members”).

On June 15, 2016, a settlement stipulation (the “Securities Class Action Settlement”), was approved by the Bankruptcy Court. Subject to the approval of the Class Action Court, the Securities Class Action Settlement required the Company to issue 300,000 shares of common stock and submit a payment of \$250,000 to the Securities Class Action Members and advance insurance proceeds of \$1.25 million to the Securities Class Action Members (collectively, the consideration is the “Securities Class Action Settlement Consideration”). On January 20, 2017, the Class Action Court preliminarily approved the Securities Class Action Settlement and set a final settlement approval hearing that is now expected to occur on June 8, 2017. Subject to the final approval of the Securities Class Action Settlement, any Securities Class Action Member is entitled to share in the Securities Class Action Settlement Consideration. The Securities Class Action Settlement provides for releases and related injunctions to be granted for the benefit of, among others, the Company, Ronald Martell, Herb Cross and all of the Company’s past, present and future directors, officers and employees, excluding Mr. Shkrel. Alternatively, Securities Class Action Members may exclude themselves from the Securities Class Action Settlement and are thereby not bound by the terms of the Securities Class Action Settlement nor entitled to receive any amount of the Securities Class Action Settlement Consideration. Such Securities Class Action Members, to the extent they properly exclude themselves from the Securities Class Action Settlement and have timely and properly filed a proof of claim in the bankruptcy case, may have certain rights under the Plan with respect to such claims. Pursuant to the Plan and Confirmation Order, such claims are subordinated to the level of the Company’s common stock that was issued and outstanding when the Company’s bankruptcy case was filed. Such claims are also subject to the Company’s objection.

The Company’s agreement to the Securities Class Action Settlement was not in any way an admission of the Company’s wrongdoing or liability. During the year ended December 31, 2016, the 300,000 shares were issued and the \$250,000 payment was made.

PIPE Litigation

On January 7, 2016, certain investors (the “PIPE Claimants”), commenced an adversary proceeding (captioned *Gregory Rea, et al. v. KaloBios Pharmaceuticals, Inc.*, Adv. Pro. No. 16-50001 (LSS)) in the Bankruptcy Court against the Company alleging implied trust theories, breach of contract, fraud and violations of the federal securities laws in connection with the PIPE Claimants’ purchase of the Company’s common stock in the Private Placement (the “PIPE Litigation”). The PIPE Claimants also raised certain other objections to the Company’s bankruptcy proceeding. The PIPE Claimants sought an aggregate total of approximately \$6.9 million in damages.

On May 9, 2016, the Bankruptcy Court entered an order approving a settlement stipulation between the Company and the PIPE Claimants (the “Settlement Stipulation”). Under the Settlement Stipulation, in connection with the effectiveness of the Plan, and per the terms of the Settlement Stipulation, the Company became obligated to issue 327,608 shares to the PIPE Claimants and make a payment of \$250,000 to the PIPE Claimants for the purpose of satisfying expenses related to the PIPE Litigation. During the year ended December 31, 2016, the 327,608 shares were issued and the \$250,000 payment was made.

Claim by Marek Biestek

Marek Biestek was a director of the Company who, while not a plaintiff in the above described PIPE Litigation, filed a proof of claim alleging damages from the PIPE transaction and filed an objection to the confirmation of the Plan. To resolve his objection to the Plan and his proof of claim, the Company settled with him individually by issuing him 3,750 additional shares of common stock. Mr. Biestek, as a former director of the Company, was excluded from the Securities Class Action Members and therefore received nothing from the Securities Class Action Litigation.

As of December 31, 2015, the Company recorded an obligation in stockholders’ equity to issue the shares related to the above claims totaling approximately \$2.8 million and recorded the cash liability of \$500,000 in Liabilities subject to compromise. During the year ended December 31, 2016, all of the above claims were satisfied and shares issued.

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

You should read the following discussion and analysis together with our financial statements and the notes to those statements included elsewhere in this Quarterly Report on Form 10-Q and our Annual Report on Form 10-K for the fiscal year ended December 31, 2016. This Quarterly Report on Form 10-Q contains statements that discuss future events or expectations, projections of results of operations or financial condition, trends in our business, business prospects and strategies and other "forward-looking" information. In some cases, you can identify "forward-looking statements" by words like "may," "will," "should," "expects," "plans," "anticipates," "believes," "estimates," "predicts," "intends," "potential" or "continue" or the negative of those words and other comparable words. These statements may relate to, among other things, our expectations regarding the scope, progress, expansion, and costs of researching, developing and commercializing our product candidates; our intent to in-license or acquire additional product candidates; our opportunity to benefit from various regulatory incentives and the application of our Responsible Pricing Model; expectations for our financial results, revenue, operating expenses and other financial measures in future periods; and the adequacy of our sources of liquidity to satisfy our working capital needs, capital expenditures, and other liquidity requirements. Actual events or results may differ materially due to known and unknown risks, uncertainties and other factors such as:

- our lack of revenues, history of operating losses, limited cash reserves and ability to obtain additional capital to develop and commercialize our product candidates, including the additional capital which will be necessary to complete the clinical trials that we have initiated or plan to initiate, and continue as a going concern;
- our ability to execute our strategy and business plan;
- our ability to list our common stock on a national securities exchange, whether through a new listing or by completing a reverse merger or other strategic transaction;
- the success, progress, timing and costs of our efforts to evaluate or consummate various strategic alternatives if in the best interests of our stockholders;
- the availability of a 505(b)(2) development pathway for the potential approval by FDA of our benznidazole candidate as a treatment for Chagas disease remaining acceptable to FDA in the future;
- the fact that a 505(b)(2) pathway does not assure a product candidate will be deemed safe or effective, or that FDA approval will be obtained;
- the requirement that we be first to receive FDA approval for benznidazole as a treatment for Chagas disease as a prerequisite to our ability to apply for or receive a Priority Review Voucher in respect of that candidate;
- uncertainties relating to the timetable for FDA action under the new presidential administration;
- the potential timing and outcomes of clinical studies of benznidazole, lenzilumab, ifabotuzumab or any other product candidates and the uncertainties inherent in clinical testing;
- the commercial viability of our proposed drug pricing program;
- our ability to timely source adequate supply of our development products from third-party manufacturers on which we depend;
- the potential, if any, for future development of any of our present or future products;
- our ability to successfully progress, partner or complete further development of our programs;
- our ability to identify and develop additional products;
- our ability to attain market exclusivity or to protect our intellectual property;
- our ability to sell a Priority Review Voucher on reasonable terms or at all;
- our ability to successfully commercialize benznidazole;
- our ability to reach agreement with a partner to effect a successful commercialization;
- the market for benznidazole may not be as large as expected and we may not be able to develop the market as expected;
- the profitability of commercial efforts for benznidazole may not be as expected;
- competition; and
- changes in the regulatory landscape that may prevent us from pursuing or realizing any of the expected benefits from the various regulatory incentives at the center of our strategy, or the imposition of regulations that affect our products.

These are only some of the factors that may affect the forward-looking statements contained in this Form 10-Q. For a discussion identifying additional important factors that could cause actual results to vary materially from those anticipated in the forward-looking statements, see “Risk Factors” in Item 1A of Part I of our Annual Report on Form 10-K for the fiscal year ended December 31, 2016. You should review these risk factors for a more complete understanding of the risks associated with an investment in our securities. However, we operate in a competitive and rapidly changing environment and new risks and uncertainties emerge, are identified or become apparent from time to time. It is not possible for us to predict all risks and uncertainties that could have an impact on the forward-looking statements contained in this Form 10-Q. You should be aware that the forward-looking statements contained in this Form 10-Q are based on our current views and assumptions. We undertake no obligation to revise or update any forward-looking statements made in this Form 10-Q to reflect events or circumstances after the date hereof or to reflect new information or the occurrence of unanticipated events, except as required by law. The forward-looking statements in this Form 10-Q are intended to be subject to protection afforded by the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995.

Overview

We are a biopharmaceutical company focused on developing medicines for patients with neglected and rare diseases, with an ancillary focus on pediatric conditions, and on executing our Responsible Pricing Model in the commercialization of our products that may be approved. Our lead product candidate is benznidazole for the treatment of Chagas disease, a parasitic illness that can lead to long-term heart, intestinal and neurological problems. We are developing one of our proprietary monoclonal antibodies, lenzilumab (formerly known as KB003), for the treatment of chronic myelomonocytic leukemia, or CMML, and potentially for the treatment of juvenile myelomonocytic leukemia, or JMML, both of which are rare hematologic cancers with high unmet medical need. We are exploring partnering opportunities to enable development of ifabotuzumab (another of our proprietary monoclonal antibodies, formerly known as KB004), for the potential treatment of serious pulmonary conditions and certain rare solid and hematologic cancers and KB001-A which was being developed for the treatment of lung infections related to cystic fibrosis. With a focus on neglected, rare and orphan diseases, we believe we have the opportunity to benefit from various regulatory incentives, such as orphan drug exclusivity, breakthrough therapy designation, fast track designation, accelerated approval, priority review and priority review vouchers, or PRVs, where available, that provide for certain periods of exclusivity, expedited review and/or other benefits.

Upon regulatory approval of any of our products, we intend to apply our Responsible Pricing Model, which focuses on affordability for patients and payers, transparency for all stakeholders, and delivery of a reasonable return in recognition of the risks we are taking in our development efforts.

Benznidazole is an oral small molecule antiprotozoal for the treatment of Chagas disease, which is also known as American trypanosomiasis. Benznidazole has undergone numerous clinical trials and studies that show efficacy against Chagas disease and we believe it is the current preferred treatment for Chagas disease in the countries where it is approved. No treatments for Chagas disease are approved by the United States Food and Drug Administration, or FDA, for use in the United States. On June 30, 2016, we acquired certain worldwide rights relating to benznidazole for human use from Savant Neglected Diseases, LLC, or Savant, and we are focused on the development necessary to seek and obtain FDA approval of benznidazole and the subsequent commercialization, if approved. After a meeting with FDA in December 2016, we believe benznidazole, as a treatment for Chagas disease, could qualify for priority review and potentially other FDA regulatory incentives, and to receive a PRV if FDA approves the drug for marketing. FDA also confirmed at our December 2016 meeting, that it would be permissible for us to submit an IND application for benznidazole to FDA under the 505(b)(2) regulatory pathway, which we expect to do during the first half of 2017.

If our work to submit the NDA for benznidazole progresses on the timeline laid out above, we anticipate that FDA’s decision related to approval of our NDA could occur before the end of 2018. As a result, we have begun preliminary commercial planning activities, including exploring monetization opportunities associated with potential receipt of a PRV, developing possible launch and commercialization strategies in the U.S. and seeking ways to generate revenue outside of the U.S. through partnerships.

Lenzilumab is a recombinant monoclonal antibody, or mAb, that neutralizes soluble granulocyte-macrophage colony-stimulating factor, or GM-CSF, a critical cytokine for the growth of certain hematologic malignancies and solid tumors and may be implicated in other serious conditions. Consistent with our strategic focus on neglected and rare diseases, in July 2016, we initiated dosing in a Phase 1 clinical trial in patients with CMML to identify the maximum tolerated dose, or MTD, or recommended Phase 2 dose of lenzilumab and to assess lenzilumab’s safety, pharmacokinetics, and clinical activity. We may assess interim data from the lenzilumab CMML Phase I study to determine the feasibility of rapidly commencing a Phase I study in JMML patients, or explore progressing directly with the JMML Phase I study. JMML is associated with a very high unmet medical need and there are no FDA-approved therapies.

Ifabotuzumab is an anti-EphA3 mAb that has the potential to offer a novel approach to treating serious pulmonary conditions, as well as solid tumors and hematologic malignancies. EphA3 is aberrantly expressed on the surface of tumor cells and stroma cells in certain cancers. We have completed the Phase 1 dose escalation portion of a Phase 1/2 clinical trial in ifabotuzumab in multiple hematologic malignancies and are evaluating partnering opportunities for ifabotuzumab.

We also have an additional drug candidate, KB001-A, a recombinant, PEGylated, anti-Pseudomonas PcrV high-affinity Fab antibody that we are no longer developing, but which is available for partnering.

Lenzilumab, ifabotuzumab and KB001-A were each developed with our proprietary, patent-protected Humaneered® technology, which consists of methods for converting antibodies (typically murine) into engineered, high-affinity antibodies designed for human therapeutic use, typically for chronic conditions.

Our strategy also involves identifying, acquiring, developing and supporting the commercialization of additional treatments for neglected and rare diseases. We believe the treatment of neglected and rare diseases represents an opportunity to enter underserved patient populations and serve specialty markets. We also believe our focus on neglected and rare diseases provides us the opportunity to benefit from various regulatory incentives referenced above. The potential opportunities afforded by these regulatory programs provide an important incentive to support our efforts to develop medicines for patients with neglected and rare diseases and to apply our Responsible Pricing Model for any of our approved products.

We have incurred significant losses and had an accumulated deficit of \$246.2 million as of March 31, 2017. We expect to continue to incur net losses as we develop our drug candidates, expand clinical trials for our drug candidates currently in clinical development, expand our development activities and seek regulatory approvals. Significant capital is required to continue to develop and to launch a product and many expenses are incurred before revenue is received, if any. We are unable to predict the extent of any future losses or when we will receive revenue or become profitable, if at all.

We will require substantial additional capital to continue as a going concern and to support our business efforts, including obtaining regulatory approvals for benznidazole or other product candidates, clinical trials and other studies, and, if approved, the commercialization of our product candidates. We anticipate that in the future we will seek additional financing from a number of sources, including, but not limited to, the sale of equity or debt securities, strategic collaborations, and licensing of our product candidates. Additional funding may not be available to us on a timely basis or on acceptable terms, if at all. Our ability to access capital when needed is not assured and, if not achieved on a timely basis, would materially harm our business, financial condition and results of operations. If adequate funds are not available, we may be required to delay, reduce the scope of, or eliminate one or more of our development programs. We may also be required to sell or license to others our technologies, product candidates, or development programs that we would have preferred to develop and commercialize ourselves and on less than favorable terms, if at all. If in the best interest of our stockholders, we may also find it appropriate to enter into a strategic transaction that could result in, among other things, a sale, merger, consolidation or business combination.

If we are unsuccessful in efforts to raise additional capital, based on our current levels of operating expenses, our current capital will not be sufficient to fund our operations for the next twelve months. These conditions raise substantial doubt about our ability to continue as a going concern. The Condensed Consolidated Financial Statements for the quarter ended March 31, 2017, were prepared on the basis of a going concern, which contemplates that we will be able to realize our assets and discharge liabilities in the normal course of business. Our ability to meet our liabilities and to continue as a going concern is dependent upon the availability of future funding. The financial statements do not include any adjustments that might be necessary if we are unable to continue as a going concern.

As a result of challenges facing us at the time, on December 29, 2015, we filed a voluntary petition for bankruptcy protection under Chapter 11 of Title 11 of the U.S. Bankruptcy Code. On June 30, 2016, our Second Amended Plan of Reorganization, dated May 9, 2016, as amended, or the Plan, became effective and we emerged from our Chapter 11 bankruptcy proceedings. For further information on our bankruptcy and emergence from bankruptcy, see Note 2 to the Condensed Consolidated Financial Statements included in Item 1 of this Quarterly Report on Form 10-Q.

On January 13, 2016, our common stock was suspended from the Nasdaq Global Market and began trading on the over-the-counter market under the ticker symbol KBIOQ. On January 26, 2016, NASDAQ filed a Form 25 with the Securities and Exchange Commission to complete the delisting of our common stock, and the delisting was effective on February 5, 2016. On June 30, 2016, upon emergence from bankruptcy, the ticker symbol for the trading of the Company's common stock on the over-the-counter market reverted back to KBIO.

Critical Accounting Policies and Use of Estimates

Our management's discussion and analysis of our financial condition and results of operations is based on our Condensed Consolidated Financial Statements, which have been prepared in accordance with accounting principles generally accepted in the United States, or GAAP. The preparation of our financial statements in conformity with GAAP requires our management to make estimates and assumptions that affect the amounts and disclosures reported in the financial statements and accompanying notes. Actual results could differ materially from those estimates. Our management believes judgment is involved in determining revenue recognition, valuation of financing derivative, the fair value-based measurement of stock-based compensation, accruals and warrant valuations. Our management evaluates estimates and assumptions as facts and circumstances dictate. As future events and their effects cannot be determined with precision, actual results could differ from these estimates and assumptions, and those differences could be material to the Condensed Consolidated Financial Statements. If our assumptions change, we may need to revise our estimates, or take other corrective actions, either of which may also have a material adverse effect on our statements of operations, liquidity and financial condition.

We are an emerging growth company under the JOBS Act. Emerging growth companies can delay adopting new or revised accounting standards until such time as those standards apply to private companies. We have elected to avail ourselves of this exemption from new or revised accounting standards and, therefore, we may not be subject to the same new or revised accounting standards as other public companies that are not emerging growth companies.

There were no significant and material changes in our critical accounting policies and use of estimates during the three months ended March 31, 2017, as compared to those disclosed in "Management's Discussion and Analysis of Financial Condition and Results of Operations—Critical Accounting Policies and Use of Estimates" in our 2016 Annual Report on Form 10-K (File No. 001-35798), filed with the SEC on March 9, 2017.

Results of Operations

General

We have not generated net income from operations, except for the year ended December 31, 2007 during which we recognized a one-time license payment from Novartis. At March 31, 2017 we had an accumulated deficit of \$246.2 million primarily as a result of research and development and general and administrative expenses. While we may in the future generate revenue from a variety of sources, including license fees, milestone payments, and research and development payments in connection with strategic partnerships, our product candidates may never be successfully developed or commercialized and we may therefore never realize revenue from any product sales, particularly because most of our product candidates are at an early stage of development. Accordingly, we expect to continue to incur substantial losses from operations for the foreseeable future, and there can be no assurance that we will ever generate significant revenue or profits.

Our operations during the three months ended March 31, 2016 primarily related to our status as a debtor in possession and other matters in connection with our Chapter 11 bankruptcy proceedings, in addition to our efforts to obtain certain rights related to our lead product candidate benznidazole. Our operations during the three months ended March 31, 2017, which are now largely related to advancing our development programs, have changed substantially from the same period in 2016. Accordingly, comparisons of our operations and results for the three months ended March 31, 2017 to our operations and results in the prior year period may only provide a limited benefit, and similarly should not be relied on as an indicator of our future operations or results.

Research and Development Expenses

Conducting research and development is central to our business model. We expense both internal and external research and development costs as incurred. We track external research and development costs incurred by project for each of our clinical programs. We began tracking our external costs by project beginning January 1, 2008, and we have continued to refine our systems and our methodology in tracking external research and development costs. Our external research and development costs consist primarily of:

- expenses incurred under agreements with contract research organizations, investigative sites, and consultants that conduct our clinical trials and a substantial portion of our preclinical activities;
- the cost of acquiring and manufacturing clinical trial and other materials; and
- other costs associated with development activities, including additional studies.

Other research and development costs consist primarily of internal research and development costs such as salaries and related fringe benefit costs for our employees (such as workers compensation and health insurance premiums), stock-based compensation charges, travel costs, lab supplies, overhead expenses such as rent and utilities, and external costs not allocated to one of our clinical programs. Internal research and development costs generally benefit multiple projects and are not separately tracked per project.

The following table shows our total research and development expenses for the three months ended March 31, 2017 and 2016:

| (in thousands) | Three Months Ended March 31, | |
|--------------------------------|------------------------------|-----------------|
| | 2017 | 2016 |
| External Costs | | |
| KB001 | \$ - | \$ 5 |
| Lenzilumab | 69 | 77 |
| Ifabotuzumab | 64 | 115 |
| Benznidazole | 1,880 | 847 |
| Internal costs | 656 | 660 |
| Total research and development | <u>\$ 2,669</u> | <u>\$ 1,704</u> |

General and Administrative Expenses

General and administrative expenses consist principally of personnel-related costs, professional fees for legal, consulting, audit and tax services, rent and other general operating expenses not otherwise included in research and development.

Comparison of Three Months Ended March 31, 2017 and 2016

| (in thousands) | Three Months Ended March 31, | | Increase/ (Decrease) | |
|----------------------------|------------------------------|-------------------|----------------------|----------|
| | 2017 | 2016 | in thousands | % |
| Operating expenses: | | | | |
| Research and development | \$ 2,669 | \$ 1,704 | \$ 965 | 57 |
| General and administrative | 2,449 | 1,205 | 1,244 | 103 |
| Loss from operations | (5,118) | (2,909) | 2,209 | 76 |
| Interest expense | (291) | - | 291 | 100 |
| Other expense, net | (15) | - | 15 | 100 |
| Reorganization items, net | (124) | (2,517) | (2,393) | (95) |
| Net loss | <u>\$ (5,548)</u> | <u>\$ (5,426)</u> | <u>\$ 122</u> | <u>2</u> |

Research and development expenses increased \$1.0 million, from \$1.7 million for the three months ended March 31, 2016 to \$2.7 million for the three months ended March 31, 2017. The increase is primarily due to an increase in costs related to the development of benznidazole offset somewhat by a decrease in other external project costs as well as internal development costs.

General and administrative expenses increased \$1.2 million from \$1.2 million for the three months ended March 31, 2016 to \$2.4 million for the three months ended March 31, 2017. The increase is primarily due to an increase in stock based compensation expense related to the issuance of options to management, consultants and board members subsequent to the emergence from bankruptcy.

Reorganization items, net, decreased \$2.4 million from \$2.5 million for the three months ended March 31, 2016 to \$0.1 million for the three months ended March 31, 2017. The decrease is primarily related to the decrease in legal fees in 2017 as compared to the legal fees incurred in the first quarter of 2016 which were primarily related to the Plan and efforts towards emergence from bankruptcy.

Interest expense of \$0.3 million recognized for the three months ended March 31, 2017 relates to interest accrued on the December 2016 Term Loan, interest accrued on the March 2017 Term Loan and interest accrued on the Notes payable to vendors. There was no Interest expense for the three months ended March 31, 2016.

Other expense, net for the three months ended March 31, 2017 consists of foreign currency losses related to the payment of vendor invoices in foreign currencies as well as state franchise taxes. There was no Other expense, net for the three months ended March 31, 2016.

Liquidity and Capital Resources

Since our inception, we have financed our operations primarily through proceeds from the public offerings of our common stock, private placements of our preferred stock, debt financings, interest income earned on cash, and cash equivalents, and marketable securities, borrowings against lines of credit, and receipts from agreements with Sanofi and Novartis. At March 31, 2017, we had cash and cash equivalents of \$4.0 million. As of May 10, 2017, we had cash and cash equivalents of \$1.7 million.

The following table sets forth the primary sources and uses of cash and cash equivalents for each of the periods presented below:

| (in thousands) | Three Months Ended March 31, | |
|---|---------------------------------|------------|
| | 2017 | 2016 |
| Net cash used in operating activities | \$ (4,365) | \$ (1,997) |
| Net cash provided by investing activities | — | 143 |
| Net cash provided by financing activities | 5,500 | — |
| Net decrease in cash and cash equivalents | \$ 1,135 | \$ (1,854) |

Net cash used in operating activities was \$4.4 million and \$2.0 million for the three months ended March 31, 2017 and 2016, respectively. The primary use of cash in 2017 was to fund our operations related to the development of our product candidates, whereas the primary use of cash in 2016 was to fund our operations related to the Plan. Cash used in operating activities of \$4.4 million for the three months ended March 31, 2017 primarily related to our net loss of \$5.5 million, adjusted for non-cash items, such as \$1.1 million in stock based compensation, \$0.3 million in noncash interest expense and net cash outflows of \$0.3 million related to changes in operating assets and liabilities, primarily Prepaid expenses and other assets, Liabilities subject to compromise, Accounts payable and Accrued expenses.

Net cash used in operating activities of \$2.0 million for the three months ended March 31, 2016 primarily related to our net loss of \$5.4 million, adjusted for non-cash items, such as a gain on lease termination of \$0.2 million and net cash inflows of \$3.6 million related to changes in operating assets and liabilities, primarily Prepaid expenses and other assets, Liabilities subject to compromise, Accounts payable and Accrued expenses.

Net cash provided by investing activities was \$0.1 million for the three months ended March 31, 2016, primarily related to the reduction in restricted cash in connection with the termination of our former office lease in South San Francisco. There was no Net cash provided by investing activities for the three months ended March 31, 2017.

Net cash provided by financing activities was \$5.5 million for the three months ended March 31, 2017 related to the March 2017 Term Loan. There was no Net cash provided by financing activities for the three months ended March 31, 2016.

In connection with our emergence from bankruptcy in June 2016, we closed an \$11 million financing that provided the funds required to enable our exit from Chapter 11, as well as to fund our current working capital needs. In December 2016, we entered into a Credit and Security Agreement (the “Term Loan Credit Agreement”) providing for an original \$3.0 million credit facility (the “December 2016 Term Loan”), net of certain fees and expenses. On March 21, 2017, we entered into an amendment to the Term Loan Credit Agreement to obtain an additional \$5.5 million (the “March 2017 Term Loan”), net of certain fees and expenses, providing additional working capital. Please see Note 7 to the Condensed Consolidated Financial Statements included in Item 1 of this Quarterly Report on Form 10-Q, for additional information relating to the Term Loan Credit Agreement. However, we will require substantial additional capital to continue as a going concern and to support our business efforts, including obtaining regulatory approvals for benznidazole or other product candidates, clinical trials and other studies, and, if approved, the commercialization of our product candidates. The amount of capital we will require and the timing of our need for additional capital will depend on many factors, including:

- the availability of a 505(b)(2) development pathway for the potential approval by FDA of benznidazole;
- the type, number, timing, progress, costs, and results of the product candidate development programs that we are pursuing or may choose to pursue in the future;
- the scope, progress, expansion, costs, and results of our pre-clinical and clinical trials;
- the timing of and costs involved in obtaining regulatory approvals;
- the success, progress, timing and costs of our efforts to evaluate or consummate various strategic alternatives if in the best interests of our stockholders;
- our ability to re-list our common stock on a national securities exchange, whether through a new listing or by completing a strategic transaction;
- our ability to establish and maintain development partnering arrangements and any associated funding;
- the emergence of competing products or technologies and other adverse market developments;
- the costs of maintaining, expanding, and protecting our intellectual property portfolio, including potential litigation costs and liabilities;
- the resources we devote to marketing, and, if approved, commercializing our product candidates;
- the scope, progress, expansion and costs of manufacturing our product candidates; and
- the costs associated with being a public company.

We are pursuing efforts to raise additional capital from a number of sources, including, but not limited to, the sale of equity or debt securities, strategic collaborations, and licensing of our product candidates. Additional funding may not be available to us on a timely basis or at acceptable terms, if at all. Our ability to access capital when needed is not assured and, if not achieved on a timely basis, would materially harm our business, financial condition and results of operations. If adequate funds are not available, we may be required to delay, reduce the scope of, or eliminate one or more of our development programs. We may also be required to sell or license to others our technologies, product candidates, or development programs that we would have preferred to develop and commercialize ourselves and on less than favorable terms, if at all. If in the best interests of our stockholders, we may also find it appropriate to enter into a strategic transaction that could result in, among other things, a sale, merger, consolidation or business combination.

If we are unsuccessful in efforts to raise additional capital, based on our current levels of operating expenses, our current capital will not be sufficient to fund our operations for the next twelve months. These conditions raise substantial doubt about our ability to continue as a going concern.

On January 13, 2016, our common stock was suspended from the Nasdaq Global Market and began trading on the over-the-counter market under the ticker symbol KBIOQ. On January 26, 2016, NASDAQ filed a Form 25 with the Securities and Exchange Commission to complete the delisting of our common stock, and the delisting was effective on February 5, 2016. On June 30, 2016, upon emergence from bankruptcy, the ticker symbol for the trading of our common stock on the over-the-counter market reverted back to KBIO. Although our common stock is eligible to trade in the OTC Grey marketplace operated by OTC Markets Group, Inc., trading is limited and an active market for our common stock may never develop in the future, which could harm our ability to raise capital to continue to fund operations.

Off-Balance Sheet Arrangements

We currently have no off-balance sheet arrangements, such as structured finance, special purpose entities or variable interest entities.

Item 4. Controls and Procedures.

Management’s Evaluation of our Disclosure Controls and Procedures

“Disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934, as amended, or the Exchange Act, means controls and other procedures that are designed 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.

Disclosure controls and procedures include, without limitation, those designed to ensure that this information is accumulated and communicated to our management to allow timely decisions regarding required disclosure. Management, including our Chief Executive Officer and Interim Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based upon the evaluation our Chief Executive Officer and Interim Chief Financial Officer concluded that the disclosure controls and procedures were effective as of March 31, 2017 to ensure that information required to be disclosed in the reports we file and submit under the Exchange Act is (i) recorded, processed, summarized and reported as and when required and (ii) accumulated and communicated to our management, including our Chief Executive Officer and Interim Chief Financial Officer, as appropriate to allow timely discussion regarding required disclosure.

Changes in Internal Control Over Financial Reporting

There has been no change in our internal control over financial reporting during the quarter ended March 31, 2017, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Inherent Limitations of Controls

Management does not expect that our disclosure controls and procedures or our internal control over financial reporting will prevent or detect all error and all fraud. Controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. 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, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of a simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with the policies or procedures. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

Please see Note 11 to the Condensed Consolidated Financial Statements included in Item 1 of this Quarterly Report on Form 10-Q for a summary of legal proceedings.

Item 6. Exhibits.

A list of exhibits is set forth on the Exhibit Index immediately following the signature page of this Quarterly Report on Form 10-Q, and is incorporated herein by reference.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

KALOBIOS PHARMACEUTICALS, INC.

Date: May 11, 2017

By: /s/ Cameron Durrant
Cameron Durrant
Chief Executive Officer
(Principal Executive Officer)

Date: May 11, 2017

By: /s/ David L. Tousley
David L. Tousley
Interim Chief Financial Officer
(Principal Financial and Accounting Officer)

EXHIBIT INDEX

| Exhibit No. | Description |
|--------------------|---|
| 2.1 | Findings of Fact, Conclusions of Law, and Order Confirming Second Amended Chapter 11 Plan of Reorganization of the Registrant (incorporated by reference to Exhibit 2.1 to the Registrant's Current Report on Form 8-K (File No. 001-035798) filed on June 22, 2016). |
| 3.1 | Amended and Restated Certificate of Incorporation of the Registrant (incorporated by reference to Exhibit 3.1 to the Registrant's Current Report on Form 8-K (File No. 001-035798) filed on July 6, 2016). |
| 10.1 | Amendment to the Credit and Security Agreement dated March 21, 2017, by and among KaloBios Pharmaceuticals, Inc., Black Horse Capital Master Fund Ltd., Black Horse Capital LP, Cheval Holdings, Ltd. and Nomis Bay LTD (incorporated by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K (File No. 001-035798) filed on March 23, 2017). |
| 10.2 | Term Loan Note, dated March 21, 2017, by KaloBios Pharmaceuticals, Inc. in favor of Black Horse Capital Master Fund Ltd (incorporated by reference to Exhibit 10.2 to the Registrant's Current Report on Form 8-K (File No. 001-035798) filed on March 23, 2017). |
| 10.3 | Term Loan Note, dated March 21, 2017, by KaloBios Pharmaceuticals, Inc. in favor of Black Horse Capital LP (incorporated by reference to Exhibit 10.3 to the Registrant's Current Report on Form 8-K (File No. 001-035798) filed on March 23, 2017). |
| 10.4 | Term Loan Note, dated March 21, 2017, by KaloBios Pharmaceuticals, Inc. in favor of Cheval Holdings, Ltd (incorporated by reference to Exhibit 10.4 to the Registrant's Current Report on Form 8-K (File No. 001-035798) filed on March 23, 2017). |
| 10.5 | Term Loan Note, dated March 21, 2017, by KaloBios Pharmaceuticals, Inc. in favor of Nomis Bay LTD (incorporated by reference to Exhibit 10.5 to the Registrant's Current Report on Form 8-K (File No. 001-035798) filed on March 23, 2017). |
| 31.1 | Certification of Chief Executive Officer of the Registrant, as required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of Interim Chief Financial Officer of the Registrant, as required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1** | Certification by the Chief Executive Officer, as required by Rule 13a-14(b) or Rule 15d-14(b) and Section 1350 of Chapter 36 of Title 18 of the United States Code (18 U.S.C. §1350). |
| 32.2** | Certification by the Interim Chief Financial Officer, as required by Rule 13a-14(b) or Rule 15d-14(b) and Section 1350 of Chapter 36 of Title 18 of the United States Code (18 U.S.C. §1350). |
| 101.INS | XBRL Instance Document |
| 101.SCH | XBRL Taxonomy Extension Schema Document |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document |

** The Certifications attached as Exhibits 32.1 and 32.2 that accompanies this Quarterly Report on Form 10-Q are not deemed filed with the Securities and Exchange Commission and are not to be incorporated by reference into any filing of KaloBios Pharmaceuticals, Inc. under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, whether made before or after the date of this Form 10-Q, irrespective of any general incorporation language contained in such filing.

**CERTIFICATION PURSUANT TO
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002
CERTIFICATIONS**

I, Cameron Durrant, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of KaloBios Pharmaceuticals, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 11, 2017

/s/ Cameron Durrant

Cameron Durrant,
Chief Executive Officer
(Principal Executive Officer)

**CERTIFICATION PURSUANT TO
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002
CERTIFICATIONS**

I, David L. Tousley, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of KaloBios Pharmaceuticals, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 11, 2017

/s/ David L. Tousley
David L. Tousley
Interim Chief Financial Officer
(Principal Financial and Accounting Officer)

**CERTIFICATION OF
PRINCIPAL EXECUTIVE OFFICER
PURSUANT TO 18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

I, Cameron Durrant, certify, to the best of my knowledge, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report on Form 10-Q of KaloBios Pharmaceuticals, Inc. for the quarter ended March 31, 2017 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Quarterly Report on Form 10-Q fairly presents in all material respects the financial condition and results of operations of KaloBios Pharmaceuticals, Inc.

By: /s/ Cameron Durrant
Name: Cameron Durrant
Title: Chief Executive Officer
(Principal Executive Officer)
Date: May 11, 2017

**CERTIFICATION OF
PRINCIPAL FINANCIAL OFFICER
PURSUANT TO 18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

I, David L. Tousley, certify, to the best of my knowledge, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report on Form 10-Q of KaloBios Pharmaceuticals, Inc. for the quarter ended March 31, 2017 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Quarterly Report on Form 10-Q fairly presents in all material respects the financial condition and results of operations of KaloBios Pharmaceuticals, Inc.

By: /s/ David L. Tousley
Name: David L. Tousley
Title: Interim Chief Financial Officer
(Principal Financial and
Accounting Officer)
Date: May 11, 2017
