

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

(Mark One)

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

For the quarterly period ended September 30, 2014

OR

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

For the transition period from _____ to _____

Commission file number 0-21617

ProPhase Labs, Inc.

(Exact name of registrant as specified in its charter)

Nevada

(State or other jurisdiction of
incorporation or organization)

23-2577138

(I.R.S. Employer Identification No.)

621 N. Shady Retreat Road, Doylestown, Pennsylvania 18901

(Address of principal executive office) (Zip Code)

(215) 345-0919

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at November 13, 2014
Common Stock, \$0.0005 par value	15,463,969

ProPhase Labs, Inc. and Subsidiaries

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

ProPhase Labs, Inc. and Subsidiaries
Condensed Consolidated Balance Sheets
(in thousands, except share and per share amounts)

	September 30, 2014	December 31, 2013
	(unaudited)	
ASSETS		
Cash and cash equivalents (Note 2)	\$ 4,953	\$ 1,638
Accounts receivable, net	4,051	5,319
Inventory (Note 2)	4,180	2,521
Prepaid expenses and other current assets	2,252	1,801
Total current assets	15,436	11,279
Property, plant and equipment, net of accumulated depreciation and amortization of \$4,266 and \$4,064, respectively (Note 2)	2,484	2,564
Intangible asset, licensed technology (Note 6)	-	3,577
Total assets	\$ 17,920	\$ 17,420
LIABILITIES AND STOCKHOLDERS' EQUITY		
LIABILITIES:		
Accounts payable	\$ 2,108	\$ 1,011
Accrued advertising and other allowances	3,166	2,847
Other current liabilities	1,908	766
Total current liabilities	7,182	4,624
Other long term obligations (Note 3)	200	200
Commitments and contingencies (Note 3)	-	-
STOCKHOLDERS' EQUITY:		
Common Stock, \$.0005 par value; authorized 50,000,000; issued: 24,696,786 and 21,437,059 shares, respectively (Note 4)	12	11
Additional paid-in-capital	53,811	43,607
Accumulated deficit	(12,543)	(5,385)
Treasury stock, at cost 9,232,817 and 5,336,053 shares, respectively	(30,742)	(25,637)
Total stockholders' equity	10,538	12,596
Total liabilities and stockholders' equity	\$ 17,920	\$ 17,420

See accompanying notes to condensed consolidated financial statements

ProPhase Labs, Inc. and Subsidiaries
Condensed Consolidated Statements of Operations
(in thousands, except per share amounts)
(unaudited)

	Three Months Ended		Nine Months Ended	
	September 30, 2014	September 30, 2013	September 30, 2014	September 30, 2013
Net sales (Note 2)	\$ 5,130	\$ 5,949	\$ 13,098	\$ 15,430
Cost of sales (Note 2)	1,620	2,132	4,816	5,346
Gross profit	3,510	3,817	8,282	10,084
Operating expenses:				
Sales and marketing	875	1,091	4,724	5,163
Administration	1,917	1,306	6,228	4,521
Research and development	356	181	907	586
Impairment charge	3,577	-	3,577	-
	6,725	2,578	15,436	10,270
Income (loss) from operations	(3,215)	1,239	(7,154)	(186)
Interest income	1	-	3	2
Interest expense	(2)	(3)	(7)	(9)
Income (loss) before income tax	(3,216)	1,236	(7,158)	(193)
Income tax (Note 5)	-	-	-	-
Net income (loss)	<u>\$ (3,216)</u>	<u>\$ 1,236</u>	<u>\$ (7,158)</u>	<u>\$ (193)</u>
Basic income (loss) per share:				
Net income (loss)	<u>\$ (0.18)</u>	<u>\$ 0.08</u>	<u>\$ (0.42)</u>	<u>\$ (0.01)</u>
Diluted income (loss) per share:				
Net income (loss)	<u>\$ (0.18)</u>	<u>\$ 0.08</u>	<u>\$ (0.42)</u>	<u>\$ (0.01)</u>
Weighted average common shares outstanding:				
Basic	18,208	15,860	17,216	15,819
Diluted	18,208	16,307	17,216	15,819

See accompanying notes to condensed consolidated financial statements

ProPhase Labs, Inc. and Subsidiaries
Condensed Consolidated Statements of
Stockholders' Equity
(in thousands, except share data)
(unaudited)

	Common Stock Shares Outstanding, Net of Shares of Treasury Stock	Par Value	Additional Paid-In Capital	Accumulated Deficit	Treasury Stock	Total
Balance at December 31, 2013	16,101,006	\$ 11	\$ 43,607	\$ (5,385)	\$ (25,637)	\$ 12,596
Net loss	-	-	-	(7,158)	-	(7,158)
Share-based compensation expense (Note 4)	-	-	191	-	-	191
Treasury stock acquired pursuant to a settlement agreement (Note 4)	(3,896,764)	-	5,105	-	(5,105)	-
Common shares issued (Note 4)	<u>3,259,727</u>	<u>1</u>	<u>4,908</u>	<u>-</u>	<u>-</u>	<u>4,909</u>
Balance at September 30, 2014	<u>15,463,969</u>	<u>\$ 12</u>	<u>\$ 53,811</u>	<u>\$ (12,543)</u>	<u>\$ (30,742)</u>	<u>\$ 10,538</u>

See accompanying notes to condensed consolidated financial statements

ProPhase Labs, Inc. and Subsidiaries
Condensed Consolidated Statements of Cash Flows
(in thousands)
(unaudited)

	Nine Months Ended	
	September 30, 2014	September 30, 2013
Cash flows from operating activities:		
Net loss	\$ (7,158)	\$ (193)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	202	178
Share-based compensation expense	191	146
Impairment charge	3,577	-
Gain on sale of equipment	(6)	-
Changes in operating assets and liabilities:		
Accounts receivable	1,268	964
Inventory	(1,659)	(1,222)
Accounts payable	1,097	2
Accrued advertising and other allowances	319	(67)
Other operating assets and liabilities, net	691	473
Net cash provided by (used in) operating activities	<u>(1,478)</u>	<u>281</u>
Cash flows from investing activities:		
Capital expenditures	(122)	(324)
Proceeds from the sale of equipment	6	-
Net cash used in investing activities	<u>(116)</u>	<u>(324)</u>
Cash flows from financing activities:		
Proceeds from the exercise of stock options	-	27
Proceeds from issuance of common stock	4,909	195
Net cash provided by financing activities	<u>4,909</u>	<u>222</u>
Net increase in cash and cash equivalents	3,315	179
Cash and cash equivalents at beginning of period	<u>1,638</u>	<u>572</u>
Cash and cash equivalents at end of period	<u>\$ 4,953</u>	<u>\$ 751</u>
Supplemental disclosure of cash flow information:		
Treasury stock acquired pursuant to a settlement agreement	<u>\$ 5,105</u>	<u>\$ -</u>

See accompanying notes to condensed consolidated financial statements

ProPhase Labs, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(unaudited)

Note 1 – Organization and Business

ProPhase Labs, Inc. (“we”, “us” or the “Company”), organized under the laws of the State of Nevada, is a manufacturer, marketer and distributor of a diversified range of homeopathic and health products that are offered to the general public. We are also engaged in the research and development of potential over-the-counter (“OTC”) drug, natural base health products along with supplement, personal care and cosmeceutical products.

Our primary business is the manufacture, distribution, marketing and sale of OTC cold remedy products to consumers through national chain, regional, specialty and local retail stores. Our flagship brand is Cold-EEZE[®] Cold Remedy and our principal product is Cold-EEZE[®] Cold Remedy zinc gluconate lozenges, proven in clinical studies to reduce the duration of the common cold. In addition to Cold-EEZE[®] Cold Remedy lozenges, we market and distribute non-lozenge forms of our proprietary zinc gluconate formulation, (i) Cold-EEZE[®] Cold Remedy QuickMelts[®] and (ii) Cold-EEZE[®] Cold Remedy Oral Spray. Cold-EEZE[®] Cold Remedy Oral Spray is a liquid form of our zinc gluconate formulation that is sprayed in the mouth. Cold-EEZE[®] Cold Remedy QuickMelts[®] are fast dissolving tablets that are taken orally. Cold-EEZE[®] Cold Remedy is an established product in the health care and cold remedy market. For the three and nine months ended September 30, 2014 and 2013, we operated in one reporting segment and our revenues have come principally from our OTC cold remedy products.

We use a December 31 year-end for financial reporting purposes. References herein to the fiscal year ended December 31, 2014 shall be the term “Fiscal 2014” and references to other “Fiscal” years shall mean the year, which ended on December 31 of the year indicated. The term “we”, “us” or the “Company” as used herein also refer, where appropriate, to the Company, together with its subsidiaries unless the context otherwise requires.

Note 2 – Summary of Significant Accounting Policies

Basis of Presentation

The unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial statements and within the rules of the Securities and Exchange Commission (“SEC”) applicable to interim financial statements and therefore do not include all disclosures that might normally be required for financial statements prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”). The accompanying unaudited condensed consolidated financial statements have been prepared by management without audit and should be read in conjunction with our consolidated financial statements, including the notes thereto, appearing in our Annual Report on Form 10-K for the year ended December 31, 2013. In the opinion of management, all adjustments necessary for a fair presentation of the consolidated financial position, consolidated results of operations and consolidated cash flows, for the periods indicated, have been made. The results of operations for the nine months ended September 30, 2014 are not necessarily indicative of operating results that may be achieved over the course of the full year. Certain amounts for the three months and nine months ended September 30, 2013 have been reclassified to conform with the three months and nine months ended September 30, 2014 presentations.

Seasonality of the Business

Our net sales are derived principally from our OTC cold remedy products. Currently, our sales are influenced by and subject to fluctuations in the timing of purchase and the ultimate level of demand for our products which are a function of the timing, length and severity of each cold season. Generally, a cold season is defined as the period of September to March when the incidence of the common cold rises as a consequence of the change in weather and other factors. We generally experience in the third and fourth quarter higher levels of net sales along with a corresponding increase in marketing and advertising expenditures designed to promote our products during the cold season. Revenues and related marketing costs are generally at their lowest levels in the second quarter when consumer demand generally declines. We track health and wellness trends and develop retail promotional strategies to align our production scheduling, inventory management and marketing programs to optimize consumer purchases.

ProPhase Labs, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(unaudited)

Note 2 – Summary of Significant Accounting Policies – continued

Use of Estimates

The preparation of financial statements and the accompanying notes thereto, in conformity with GAAP, requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the respective reporting periods. Examples include the provision for bad debt, sales returns and allowances, inventory obsolescence, useful lives of property and equipment and intangible assets, impairment of property and equipment and intangible assets, income tax valuations and assumptions related to accrued advertising. When providing for the appropriate sales returns, allowances, cash discounts and cooperative incentive promotion costs (“Sales Allowances”), we apply a uniform and consistent method for making certain assumptions for estimating these provisions. These estimates and assumptions are based on historical experience, current trends and other factors that management believes to be relevant at the time the financial statements are prepared. Management reviews the accounting policies, assumptions, estimates and judgments on a quarterly basis. Actual results could differ from those estimates.

Our primary product, Cold-EEZE[®] Cold Remedy lozenges, utilizes a proprietary zinc gluconate formulation which has been clinically proven to reduce the severity and duration of common cold symptoms. Factors considered in estimating the appropriate sales returns and allowances for this product include it being (i) a unique product with limited competitors, (ii) competitively priced, (iii) promoted, (iv) unaffected for remaining shelf-life as there is no product expiration date and (v) monitored for inventory levels at major customers and third-party consumption data. In addition to Cold-EEZE[®] Cold Remedy lozenges, we market and distribute a variety of Cold-EEZE[®] Cold Remedy QuickMelts[®] and a Cold-EEZE[®] Cold Remedy Oral Spray. We also manufacture, market and distribute an organic cough drop and a Vitamin C supplement (“Organix[®]”). Each of the Cold-EEZE[®] Cold Remedy Oral Spray and QuickMelts[®] products, and Organix[®] products carry shelf-life expiration dates for which we aggregate such new product market experience data and update our sales returns and allowances estimates accordingly. Sales allowances estimates are tracked at the specific customer and product line levels and are tested on an annual historical basis, and reviewed quarterly. Additionally, we monitor current developments by customer, market conditions and any other occurrences that could affect the expected provisions relative to net sales for the period presented.

Cash Equivalents

We consider all highly liquid investments with a maturity of three months or less at the time of purchase to be cash equivalents. Cash equivalents include cash on hand and monies invested in money market funds. The carrying amount approximates the fair market value due to the short-term maturity of these investments.

Inventory Valuation

Inventory is valued at the lower of cost, determined on a first-in, first-out basis (FIFO), or market. Inventory items are analyzed to determine cost and the market value and appropriate valuation adjustments are established. At September 30, 2014 and December 31, 2013, inventory included raw material, work in progress and packaging amounts of \$1.8 million and \$1.1 million, respectively, and finished goods of \$2.4 million and \$1.4 million, respectively.

Property, Plant and Equipment

Property, plant and equipment are recorded at cost. We compute depreciation using the straight-line method for financial reporting purposes. Depreciation expense is computed in accordance with the following ranges of estimated asset lives: building and improvements - ten to thirty-nine years; machinery and equipment - three to seven years; computer software - three years; and furniture and fixtures – five years.

ProPhase Labs, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(unaudited)

Note 2 – Summary of Significant Accounting Policies – continued

Concentration of Risks

Future revenues, costs, margins, and profits will continue to be influenced by our ability to maintain our manufacturing availability and capacity together with our marketing and distribution capabilities and the regulatory requirements associated with the development of OTC and other personal care products in order to compete on a national level and/or international level.

Our business is subject to federal and state laws and regulations adopted for the health and safety of users of our products. Our OTC cold remedy products are subject to regulations by various federal, state and local agencies, including the Food and Drug Administration (“FDA”) and, as applicable, the Homeopathic Pharmacopoeia of the United States.

Financial instruments that potentially subject us to significant concentrations of credit risk consist principally of cash investments and trade accounts receivable.

We maintain cash and cash equivalents with certain major financial institutions. As of September 30, 2014, our cash balance was \$4.9 million and our bank balance was \$5.0 million. Of the total bank balance, \$577,000 was covered by federal depository insurance and \$4.5 million was uninsured at September 30, 2014.

Trade accounts receivable potentially subject us to credit concentrations from time-to-time as a consequence of the timing, payment pattern and ultimate purchase volumes or shipping schedules with our customers. We extend credit to our customers based upon an evaluation of the customer’s financial condition and credit history and generally we do not require collateral. Our broad range of customers includes many large national chain, regional, specialty and local retail stores. These credit concentrations may impact our overall exposure to credit risk, either positively or negatively, in that our customers may be similarly affected by changes in economic, regulatory or other conditions that may impact the timing and collectability of amounts due to us. At September 30, 2014 and December 31, 2013, our largest accounts receivable balances are with three customers representing approximately 51% and two customers representing 46%, respectively, of our total trade receivable balance. As a consequence of an evaluation of our customer’s financial condition, payment patterns, balance due us and other factors, we did not offset our account receivable with an allowance for bad debt at September 30, 2014 and December 31, 2013.

Our revenues are principally generated from the sale of OTC cold remedy products which represented approximately 95% and 91% of total revenues for each of the nine months ended September 30, 2014 and 2013, respectively. A significant portion of our business is highly seasonal, which causes major variations in operating results from quarter to quarter. The third and fourth quarters generally represent the largest sales volume for the OTC cold remedy products. For the three and nine months ended September 30, 2014 and 2013, our net sales were principally related to domestic markets.

ProPhase Labs, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(unaudited)

Note 2 – Summary of Significant Accounting Policies – continued

Long-lived Assets

We review our carrying value of our long-lived assets with definite lives whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. When indicators of impairment exist, we determine whether the estimated undiscounted sum of the future cash flows of such assets is less than their carrying amounts. If less, an impairment loss is recognized in the amount, if any, by which the carrying amount of such assets exceeds their respective fair values. The determination of fair value is based on quoted market prices in active markets, if available, or independent appraisals; sales price negotiations; or projected future cash flows discounted at a rate determined by management to be commensurate with our business risk. The estimation of fair value utilizing discounted forecasted cash flows includes significant judgments regarding assumptions of revenue, operating and marketing costs; selling and administrative expenses; interest rates; property and equipment additions and retirements; industry competition; and general economic and business conditions, among other factors.

Fair value is based on the prices that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In order to increase consistency and comparability in fair value measurements, a three-tier fair value hierarchy prioritizes the inputs used to measure fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets; Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs for which little or no market data exists, therefore requiring an entity to develop its own assumptions.

Fair Value of Financial Instruments

Cash and cash equivalents, accounts receivable and accounts payable are reflected in the Condensed Consolidated Financial Statements at carrying value which approximates fair value because of the short-term maturity of these instruments.

Revenue Recognition

Sales are recognized at the time ownership is transferred to the customer. Revenue is reduced for trade promotions, estimated sales returns, cash discounts and other allowances in the same period as the related sales are recorded. We make estimates of potential future product returns and other allowances related to current period revenue. We analyze historical returns, current trends, and changes in customer and consumer demand when evaluating the adequacy of the sales returns and other allowances.

Our return policy accommodates returns for (i) discontinued products, (ii) store closings and (iii) products that have reached or exceeded their designated expiration date. We do not impose a period of time within which product may be returned. All requests for product returns must be submitted to us for pre-approval. The main components of our returns policy are: (i) we will accept returns that are due to damaged product that is un-saleable and such return request activity falls within an acceptable range, (ii) we will accept returns for products that have reached or exceeded designated expiration dates and (iii) we will accept returns in the event that we discontinue a product provided that the customer will have the right to return only such items that it purchased directly from us. We will not accept return requests pertaining to customer inventory “Overstocking” or “Resets”. We will only accept return requests for product in its intended package configuration. We reserve the right to terminate shipment of product to customers who have made unauthorized deductions contrary to our return policy or pursue other methods of reimbursement. We compensate the customer for authorized returns by means of a credit applied to amounts owed or to be owed and in the case of discontinued product only, also by way of an exchange. We do not have any significant product exchange history.

ProPhase Labs, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(unaudited)

Note 2 – Summary of Significant Accounting Policies – continued

As of September 30, 2014, accrued advertising and other allowances included (i) \$2.0 million for estimated future sales returns and (ii) \$1.2 million for cooperative incentive promotion costs. As of December 31, 2013, accrued advertising and other allowances included (i) \$1.5 million for estimated future sales returns and (ii) \$1.3 million for cooperative incentive promotion costs. Additionally, as of September 30, 2014 and December 31, 2013, we included a provision for sales allowances of \$89,000 and \$128,000, respectively, which are reported as a reduction to sales and account receivables.

Advertising and Incentive Promotions

Advertising and incentive promotion costs are expensed within the period in which they are utilized. Advertising and incentive promotion expense is comprised of (i) media advertising, presented as part of sales and marketing expense, (ii) cooperative incentive promotions and coupon program expenses, which are accounted for as part of net sales, and (iii) free product, which is accounted for as part of cost of sales. Advertising and incentive promotion expenses incurred for the three months ended September 30, 2014 and 2013 were \$1.3 million and \$1.4 million, respectively. Advertising and incentive promotion expenses incurred for the nine months ended September 30, 2014 and 2013 were \$5.7 million and \$5.9 million, respectively. Included in prepaid expenses and other current assets was \$1.9 million and \$1.3 million at September 30, 2014 and December 31, 2013, respectively, relating to prepaid advertising and promotion expenses.

Shipping and Handling

Product sales carry shipping and handling charges to the purchaser, included as part of the invoiced price, which is classified as revenue. In all cases, costs related to this revenue are recorded in cost of sales.

Stock Based Compensation

We recognize all share-based payments to employees and directors, including grants of stock options, as compensation expense in the financial statements based on their fair values. Fair values of stock options are determined through the use of the Black-Scholes option pricing model. The compensation cost is recognized as an expense over the requisite service period of the award, which usually coincides with the vesting period.

Stock and stock options for the purchase of our common stock, \$0.0005 par value, (“Common Stock”) have been granted to both employees and non-employees pursuant to the terms of certain agreements and stock option plans (see Note 4). Stock options are exercisable during a period determined by us, but in no event later than ten years from the date granted. For the three months ended September 30, 2014 and 2013, we charged to operations \$63,000 and \$67,000, respectively, for share-based compensation expense for the aggregate fair value of stock grants issued and vested stock options earned. For the nine months ended September 30, 2014 and 2013, we charged to operations \$191,000 and \$146,000, respectively, for share-based compensation expense for the aggregate fair value of stock grants issued and vested stock options earned.

Variable Interest Entity

On March 22, 2010, we, Phosphagenics Limited (“PSI Parent”), an Australian corporation, Phosphagenics Inc. (“PSI”), a Delaware corporation and subsidiary of PSI Parent, and Phusion Laboratories, LLC (the “Joint Venture”), a Delaware limited liability company, entered into a Limited Liability Company Agreement (the “LLC Agreement”) of the Joint Venture and additional related agreements for the purpose of developing and commercializing, for worldwide distribution and sale, a wide range of non-prescription remedies using PSI Parent’s proprietary patented TPM™ technology (“TPM”). TPM facilitates the delivery and depth of penetration of active molecules in pharmaceutical, nutraceutical, and other products. Pursuant to the LLC Agreement, we and PSI each own a 50% membership interest in the Joint Venture. The Joint Venture, of which we own a 50% membership interest, qualifies as a variable interest entity (“VIE”), we are the current primary beneficiary and we have consolidated the Joint Venture beginning with the quarter ended March 31, 2010 (see Note 6).

ProPhase Labs, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(unaudited)

Note 2 – Summary of Significant Accounting Policies – continued

Research and Development

Research and development costs are charged to operations in the period incurred. Research and development costs for the three months ended September 30, 2014 and 2013 were \$356,000 and \$181,000, respectively. Research and development costs for the nine months ended September 30, 2014 and 2013 were \$907,000 and \$586,000, respectively. Research and development costs are principally related to new product development initiatives and costs associated with our OTC cold remedy products.

Income Taxes

We utilize the asset and liability approach which requires the recognition of deferred tax assets and liabilities for the future tax consequences of events that have been recognized in our financial statements or tax returns. In estimating future tax consequences, we generally consider all expected future events other than enactments of changes in the tax law or rates. Until sufficient taxable income to offset the temporary timing differences attributable to operations and the tax deductions attributable to option, warrant and stock activities are assured, a valuation allowance equaling the total deferred tax asset is being provided (see Note 5).

We utilize a two-step approach to recognizing and measuring uncertain tax positions. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount which is more than fifty percent likely of being realized upon ultimate settlement. Any interest or penalties related to uncertain tax positions will be recorded as interest or administrative expense, respectively.

As a result of our continuing tax losses, we have recorded a full valuation allowance against a net deferred tax asset. Additionally, we have not recorded a liability for unrecognized tax benefits. The tax years 2006 and forward remain open to examination by the IRS. The tax years 2004 and forward remain open to examination by the various state taxing authorities to which we are subject.

Recently Issued Accounting Standards

In July 2013, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2013-11, “Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists” (“ASU 2013-11”). ASU 2013-11 amends Accounting Standards Codification 740, “Income Taxes,” to require that in certain cases, an unrecognized tax benefit, or portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward when such items exist in the same taxing jurisdiction. The amendments in this update are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. The amendments should be applied prospectively to all unrecognized tax benefits that exist at the effective date, and retrospective application is permitted. The adoption of ASU 2013-11 did not have a material impact on our consolidated financial position, results from operations or cash flows.

In May 2014, the FASB issued new accounting guidance ASU No. 2014-09, “Revenue from Contracts with Customers”, on revenue recognition. The new standard provides for a single five-step model to be applied to all revenue contracts with customers as well as requires additional financial statement disclosures that will enable users to understand the nature, amount, timing and uncertainty of revenue and cash flows relating to customer contracts. Companies have an option to use either a retrospective approach or cumulative effect adjustment approach to implement the standard. There is no option for early adoption. This ASU is effective for fiscal years and interim periods within those years beginning after December 15, 2016. We are currently evaluating the impact of the new guidance on our consolidated financial statements.

ProPhase Labs, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(unaudited)

Note 2 – Summary of Significant Accounting Policies – continued

In June 2014, the FASB issued new accounting guidance ASU 2014-12, “Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period”. The amendments in this update require that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. Companies should apply existing guidance in ASC 718, “Compensation - Stock Compensation”, as it relates to awards with performance conditions that affect vesting to account for such awards. The amendments in this update will be effective as of January 1, 2016. Earlier adoption is permitted. We may apply the amendments in this update either: (1) prospectively to all awards granted or modified after the effective date; or (2) retrospectively to all awards with performance targets that are outstanding as of the beginning of the earliest annual period presented in the financial statements and to all new or modified awards thereafter. If a retrospective transition is adopted, the cumulative effect of applying this update as of the beginning of the earliest annual period presented in the financial statements should be recognized as an adjustment to the opening retained earnings balance at that date. In addition, if a retrospective transition is adopted, we may use hindsight in measuring and recognizing the compensation cost. We are currently assessing the impact of this update, and believe that its adoption on January 1, 2016 will not have a material impact on our consolidated financial statements.

In August 2014, the FASB issued ASU 2014-15, “Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern”. The amendments in this update state that in connection with preparing financial statements for each annual and interim reporting period, an entity’s management should evaluate whether there are conditions or events that raise substantial doubt about the entity’s ability to continue as a going concern within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued, when applicable). The amendments in this update are effective for the annual reporting period beginning after December 15, 2016, and for annual periods and interim periods thereafter. Early application is permitted. The adoption of ASU 2014-15 is not expected to have a material impact on our consolidated financial statements.

Note 3 – Commitments and Contingencies

Godfrey Settlement Agreement

In November 2004, we commenced an action against John C. Godfrey, Nancy Jane Godfrey, and Godfrey Science and Design, Inc. (together the “Godfreys”) for injunctive relief regarding the ownership of the Cold-EEZE[®] trademark. The Godfreys subsequently asserted against us counterclaims and sought monetary damages and injunctive and declaratory relief relative to the Cold-EEZE[®] trademark and other intellectual property.

On December 20, 2012, we and the Godfreys, including the Estate of Nancy Jane Godfrey, entered into a Settlement Agreement and Mutual General Release (the “Godfrey Settlement Agreement”), pursuant to which we resolved all disputes, including claims asserted by us and counterclaims asserted against us in the action. Pursuant to the terms of the Godfrey Settlement Agreement, we paid the Godfreys \$2.1 million in December 2012 and we agreed to make four additional annual payments of \$100,000 due in December of each of the next four years. Each annual payment in the amount of \$100,000 will accrue interest at the per annum rate of 3.25%. The first annual installment of \$100,000 plus accrued interest of \$13,000 was paid in December 2013. Under the Godfrey Settlement Agreement, the Godfreys assigned, transferred and conveyed to us all of their right, title, and interest in U.S. Trademark Registration No. 1,838,542 for the trademark Cold-EEZE[®], among other intellectual property associated with such trademark. At each of September 30, 2014 and December 31, 2013, other current liabilities and other long term obligations include \$100,000 and \$200,000, respectively, for the three remaining annual installment payments.

ProPhase Labs, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(unaudited)

Note 3 – Commitments and Contingencies – continued

We have estimated future minimum obligations over the next five years, including the remainder of Fiscal 2014, as follows (in thousands):

Fiscal Year	Employment Contracts	Settlement Agreement	Total
2014	256	100	356
2015	1,025	100	1,125
2016	256	100	356
2017	-	-	-
2018	-	-	-
Total	\$ 1,537	\$ 300	\$ 1,837

Note 4 – Transactions Affecting Stockholders' Equity

Stockholder Rights Plan

On September 8, 1998, our Board of Directors declared a dividend distribution of Common Stock Purchase Rights (each individually, a "Right" and collectively, the "Rights") payable to the stockholders of record on September 25, 1998, thereby creating a Stockholder Rights Plan (the "Rights Agreement"). The Plan was subsequently amended effective each of (i) May 23, 2008, (ii) August 18, 2009 and (iii) June 18, 2014. The Rights Agreement, as amended, provides that each Right entitles the stockholder of record to purchase from the Company that number of common shares having a combined market value equal to two times the Rights exercise price of \$45. The Rights are not exercisable until the distribution date, which will be the earlier of a public announcement that a person or group of affiliated or associated persons has acquired 15% or more of the outstanding common shares, or the announcement of an intention by a similarly constituted party to make a tender or exchange offer resulting in the ownership of 15% or more of the outstanding common shares. The Rights Agreement allows for an exemption for Ted Karkus, the Company's Chairman and Chief Executive Officer, to acquire up to 20% of our Common Stock without our Board of Directors declaring a dividend distribution. The dividend has the effect of giving the stockholder a 50% discount on the share's current market value for exercising such right. In the event of a cashless exercise of the Right and the acquirer has acquired less than 50% beneficial ownership of the Company, a stockholder may exchange one Right for one common share of the Company. The Rights Agreement, as amended, includes a provision pursuant to which our Board of Directors may exempt from the provisions of the Rights Agreement an offer for all outstanding shares of our Common Stock that the directors determine to be fair and not inadequate and to otherwise be in the best interests of the Company and its stockholders, after receiving advice from one or more investment banking firms. The expiration date of the Rights Agreement, as amended, is June 18, 2024.

Treasury Stock Acquired Pursuant to a Settlement Agreement

Effective September 4, 2014, we consummated a definitive, global Settlement Agreement ("Settlement Agreement") resolving all of our litigation with certain of the Company's former managers and with certain shareholders. The cases that have been settled include *ProPhase Labs, Inc. v. Quigley, et al.*, Court of Common Pleas of Bucks County, Pennsylvania, Civ. A. No. 2010-08227; *ProPhase Labs, Inc. v. Quigley, et al.*, Court of Common Pleas of Bucks County, Pennsylvania, Civ. A. No. 2011-09815; the appeal filed by the plaintiff in the matter *Quigley v. ProPhase Labs, Inc.'s Officers and Directors, et al.*, Court of Common Pleas of Philadelphia County, December Term, 2011, No. 111200409; together with certain ancillary litigation.

ProPhase Labs, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(unaudited)

Note 4 – Transactions Affecting Stockholders' Equity – continued

The Settlement Agreement amicably resolved these matters and provided, in part, that the parties adverse to the Company in the two Bucks County cases (i) returned to the Company 3,896,764 shares of the Company's Common Stock for which they are listed as the record owners to the Company; and (ii) paid \$440,000 to the Company. In addition, the Company paid \$500,000 to the benefit of one of the defendants and \$37,000 to a third party, to defray certain costs and expenses associated with the Settlement Agreement. The payments received and the payments made pursuant to the Settlement Agreement resulted in a net charge to administration expense of \$97,000 for the three months and nine months ended September 30, 2014. We have also included in accrued expenses at September 30, 2014 \$1.3 million in unpaid litigation costs related to this matter which are expected to be paid prior to December 31, 2014 in a combination of cash and our Common Stock. Pursuant to the Settlement Agreement, the parties also have agreed to (i) a mutual release of all claims, (ii) a standstill agreement whereby, for a period of ten years, the adverse parties will not acquire Company shares, and (iii) the dismissal of all pending litigation involving the Company, its directors and affiliates on the one hand, and the other parties.

The 3,896,764 shares of Common Stock received pursuant to the terms of the Settlement Agreement were recorded as treasury stock and as an additional contribution to our additional paid-in capital, valued at \$5.1 million, or \$1.31 per share, representing the fair value of the shares at September 4, 2014.

2012 Equity Line of Credit

On November 21, 2012, we entered into the equity line of credit agreement (such arrangement, the "2012 Equity Line") with Dutchess Opportunity Fund II, LP ("Dutchess") whereby Dutchess committed to purchase, subject to certain restrictions and conditions, up to 2,500,000 shares of our Common Stock, over a period of 36 months from the first trading day following the effectiveness of the registration statement registering the resale of shares purchased by Dutchess pursuant to the 2012 Equity Line. On November 26, 2012, we filed a registration statement with Securities and Exchange Commission ("SEC") to register for sale for up to 2,500,000 shares of our Common Stock and the registration statement was deemed effective by the SEC on December 12, 2012. We amended this registration statement effective May 29, 2014 to withdraw and remove from registration all unissued and unsold shares. We also agreed with Dutchess to terminate the 2012 Equity Line as of May 28, 2014.

We drew on the facility from time to time, as and when we determine appropriate in accordance with the terms and conditions of the 2012 Equity Line. The maximum amount that we were entitled to put to Dutchess in any one draw down notice is the greater of (i) 500% of the average daily volume of our Common Stock traded on the NASDAQ Global Market for the one trading day prior to the date of delivery of the applicable draw down notice, multiplied by the closing price for such trading day, or (ii) \$250,000.

The purchase price under the 2012 Equity Line is set at ninety-five percent (95%) of the lowest daily volume weighted average price ("VWAP") of our Common Stock during the five (5) consecutive trading day period beginning on the date of delivery of the applicable draw down notice. In the event Dutchess received more than a five percent (5%) return on the net sales for a specific put, Dutchess remitted such excess proceeds to us; however, in the event Dutchess received less than a five percent (5%) return on the net sales for a specific put Dutchess had the right to use any such excess proceeds to off-set against the aggregated deficit proceeds.

There were put restrictions applied on days between the draw down notice date and the closing date with respect to that particular put. During such time, we are not allowed to deliver another draw down notice. In addition, Dutchess is not obligated to purchase shares if its total number of shares beneficially held at that time would exceed 9.99% of the number of shares of our Common Stock as determined in accordance with Rule 13d-1(j) of the Securities Exchange Act of 1934, as amended. In addition, we are not permitted to draw on the facility unless there is an effective registration statement to cover the resale of the shares.

ProPhase Labs, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(unaudited)

Note 4 – Transactions Affecting Stockholders' Equity – continued

During the period January 1, 2014 through May 23, 2014, we sold an aggregate of 698,207 shares of Common Stock to Dutchess under and pursuant to the 2012 Equity Line and we derived net proceeds of \$1.2 million. The sales of the shares under the 2012 Equity Line were deemed to be exempt from registration under the Securities Act of 1933, as amended in reliance upon Section 4(2) (or Regulation D promulgated thereunder).

2014 Equity Line of Credit

The Company and Dutchess executed a new equity line of credit agreement (such arrangement, the "2014 Equity Line") each dated May 28, 2014 whereby Dutchess committed to purchase, subject to certain restrictions and conditions, up to 3,000,000 shares of the Company's Common Stock, over a period of 36 months from the effectiveness of the registration statement registering the resale of shares purchased by Dutchess pursuant to the Investment Agreement. On May 29, 2014, we filed a registration statement with the SEC to register for sale up to 3,000,000 shares of our Common Stock and the registration statement was declared effective by the SEC on June 4, 2014.

We may in our discretion draw on the facility from time to time, as and when we determine appropriate in accordance with the terms and conditions of the 2014 Equity Line. The maximum number of shares that the Company is entitled to put to Dutchess in any one draw down notice shall not exceed shares with a purchase price of \$500,000, calculated in accordance with the 2014 Equity Line. We may deliver a notice for a subsequent put from time to time, following the one day pricing period for the prior put.

The purchase price shall be set at ninety-five percent (95%) of the VWAP of the Company's Common Stock during the one trading day immediately following our put notice. The Company has the right to withdraw all or any portion of any put, except that portion of the put that has already been sold to a third party, including any portion of a put that is below the minimum acceptable price set forth on the put notice, before the closing. In the event Dutchess receives more than a five percent (5%) return on the net sales for a specific put, Dutchess must remit such excess proceeds to the Company; however, in the event Dutchess receives less than a five percent (5%) return on the net sales for a specific put, Dutchess will have the right to deduct from the proceeds of the put amount on the applicable closing date so Dutchess's return will equal five percent (5%).

There are put restrictions applied on days between the draw down notice date and the closing date with respect to that particular put. During such time, the Company shall not be entitled to deliver another draw down notice. In addition, the Investor will not be obligated to purchase shares if Dutchess's total number of shares beneficially held at that time would exceed 4.99% of the number of shares of our Common Stock as determined in accordance with Rule 13d-1(j) of the Securities Exchange Act of 1934, as amended. In addition, we are not permitted to draw on the facility unless there is an effective registration statement to cover the resale of the shares.

During the period June 13, 2014 through September 30, 2014, we sold an aggregate of 2,561,520 shares of our Common Stock to Dutchess under and pursuant to the 2014 Equity Line and we derived net proceeds of \$3.7 million. The sales of the shares under the 2014 Equity Line were deemed to be exempt from registration under the Securities Act of 1933, as amended in reliance upon Section 4(2) (or Regulation D promulgated thereunder). At September 30, 2014, we have 438,480 shares of our Common Stock available for sale, at our discretion, under the terms of the 2014 Equity Line and covered pursuant to a registration statement.

ProPhase Labs, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(unaudited)

Note 4 – Transactions Affecting Stockholders' Equity – continued

The 1997 Option Plan

On December 2, 1997, our Board of Directors approved a Stock Option Plan (the "1997 Plan"), which was amended in 2005, and provided for the granting of up to 4.5 million shares of Common Stock. Under the 1997 Plan, we were permitted to grant options to employees, officers or directors of the Company at variable percentages of the market value of stock at the date of grant. No incentive stock option could be exercisable more than ten years after the date of grant or five years after the date of grant where the individual owns more than ten percent of the total combined voting power of all classes of stock. Stockholders approved the 1997 Plan in Fiscal 1998. No options were granted under this Plan for the nine months ended September 30, 2014 or 2013.

We are precluded from issuing any additional options or grants in the future under the 1997 Plan pursuant to the terms of the plan document. Options previously granted continue to be available for exercise at any time prior to such options' respective expiration dates, but in no event later than ten years from the date granted. At September 30, 2014, there are 67,000 options outstanding under the 1997 Plan with various expiration dates ranging from October 2014 through December 2015, depending upon the date of grant.

The 2010 Equity Compensation Plan

On May 5, 2010, our shareholders approved the 2010 Equity Compensation Plan which was subsequently amended, restated and approved by shareholders on April 24, 2011 and further amended and approved by shareholders on May 6, 2013 (the "2010 Plan"). The 2010 Plan provides that the total number of shares of Common Stock that may be issued under the 2010 Plan is equal to 1.6 million shares plus up to 900,000 shares that are authorized for issuance but unissued under the 1997 Plan for an aggregate of 2.5 million shares. The 1997 Plan expired on December 2, 2007 and no additional awards may be made. As of September 30, 2014, 1,481,750 of the options issued under the 1997 Plan prior to December 2007 expired unexercised or were terminated. As a consequence, these shares are deemed and remain unissued which up to a maximum of 900,000 shares became available for issuance under the 2010 Plan and the remaining 581,750 options are deemed cancelled. No options were granted under the 2010 Plan for the nine months ended September 30, 2014. We granted 15,000 options under the 2010 Plan for the three and nine months ended September 30, 2013. At September 30, 2014, there are 267,159 shares of Common Stock that may be issued pursuant to the terms of the 2010 Equity Compensation Plan.

There were no stock options exercised for the nine months ended September 30, 2014 or 2013.

The 2010 Directors' Equity Compensation Plan

On May 5, 2010, our shareholders approved the 2010 Directors' Equity Compensation Plan which was subsequently amended and approved by shareholders on May 6, 2013. A primary purpose of the 2010 Directors' Equity Compensation Plan is to provide us with the ability to pay all or a portion of the fees of directors in restricted stock instead of cash. The 2010 Directors' Equity Compensation Plan provides that the total number of shares of Common Stock that may be issued under the 2010 Directors' Equity Compensation Plan is equal to 425,000. For the three and nine months ended September 30, 2014, no shares were granted to directors. For the three and nine months ended September 30, 2013, 16,470 shares were granted to directors. At September 30, 2014, there are 176,135 shares of Common Stock that may be issued pursuant to the terms of the 2010 Directors' Equity Compensation Plan.

ProPhase Labs, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(unaudited)

Note 5 – Income Taxes

As of December 31, 2013, we have net operating loss carry-forwards of approximately \$34.7 million for federal purposes that will expire beginning in Fiscal 2020 through Fiscal 2032. Additionally, there are net operating loss carry-forwards of approximately \$20.4 million for state purposes that will expire beginning in Fiscal 2018 through Fiscal 2032. Until sufficient taxable income to offset the temporary timing differences attributable to operations and the tax deductions attributable to option, warrant and stock are assured, a valuation allowance equaling the total deferred tax asset is being provided. Management believes that this allowance is required due to the uncertainty of realizing these tax benefits in the future. The uncertainty arises largely due to substantial marketing and research and development costs.

Note 6 – Investment in a Joint Venture

On March 22, 2010, we, PSI Parent, PSI and the Joint Venture entered into the LLC Agreement of the Joint Venture and additional related agreements for the purpose of developing and commercializing, for worldwide distribution and sale, a wide range of non-prescription remedies using PSI Parent's proprietary patented TPM.

In connection with the LLC Agreement, PSI Parent granted to us, pursuant to the terms of a License Agreement, dated March 22, 2010 (the "Original License Agreement"), (i) an exclusive, royalty-free, world-wide (subject to certain limitations), paid-up license to exploit OTC drugs and certain other products that embody certain of PSI Parent's TPM-related patents and related know-how (collectively, the "PSI Technology") and (ii) a non-exclusive, royalty-free, world-wide (subject to certain limitations), paid-up license to exploit certain compounds that embody the PSI Technology for use in a product combining one or more of such compounds with an OTC drug or in a product that is part of a regimen that includes the application of an OTC drug.

The Joint Venture is managed by a four-person Board of Managers, with two managers appointed by each member. The LLC Agreement contains other normally found terms in such arrangements, including provisions relating to governance of the Joint Venture, indemnification obligations of the Joint Venture, allocation of profits and losses, the distribution of funds to the members and restrictions on transfer of a member's interest.

Pursuant to the Original License Agreement, we issued 1,440,000 shares of our Common Stock having an aggregate value of approximately \$2.6 million to PSI Parent (such shares, the "PSI Shares"), and made a one-time payment to PSI Parent of \$1.0 million.

In accordance with a Contribution Agreement, dated March 22, 2010 (the "Contribution Agreement"), by and among us, PSI Parent, PSI, and the Joint Venture, we transferred, conveyed and assigned to the Joint Venture all of our rights, title and interest in, to and under the Original License Agreement, and the Joint Venture assumed, and undertook to pay, discharge and perform when due, all of our liabilities and obligations under and arising pursuant to the Original License Agreement (such actions, collectively, the "Assignment and Assumption").

ProPhase Labs, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(unaudited)

Note 6 – Investment in a Joint Venture – continued

Pursuant to the Contribution Agreement and in order to reflect the Assignment and Assumption, we, PSI Parent and the Joint Venture entered into an Amended and Restated License Agreement, dated March 22, 2010 (the “Amended License Agreement”), which amends and restates the Original License Agreement to reflect that the Joint Venture is the licensee thereunder and which otherwise contains substantially the same terms as the Original License Agreement. The Joint Venture has the right to grant one or more sub-licenses of the rights granted under the Amended License Agreement to one or more third parties for reasonable consideration in any part of the applicable territory. The Amended License Agreement provides that PSI Parent shall not, directly or through third parties, exploit the covered intellectual property during the term thereof, subject to certain limitations. The Amended License Agreement will remain in effect until the expiration of the last to expire of the patents included within the PSI Technology or any extensions thereof. Either party may terminate the Amended License Agreement upon written notice to the other party in the event of certain events involving bankruptcy or insolvency. The Amended License Agreement also contains, among other things, provisions concerning the treatment of confidential information, the ownership of intellectual property and indemnification obligations.

Pursuant to the LLC Agreement, we and PSI each own a 50% membership interest in the Joint Venture. PSI Parent will conduct and oversee much of the product development, formulation, testing and other research and development needed by the Joint Venture, and we will oversee much of the production, distribution, sales and marketing. The LLC Agreement provides that each member may be required, from time to time and subject to certain limitations, to make capital contributions to the Joint Venture to fund its operations, in accordance with agreed upon budgets for products to be developed. Specifically, we contributed in Fiscal 2010 \$500,000 in cash as initial capital and we are committed to fund up to \$2.0 million, subject to agreed upon budgets (which have not been established to date), toward the initial development and marketing costs of new products for the Joint Venture. The Joint Venture has not engaged in any financial transactions, other than organizational expenses and general market and initial product evaluation and analysis. At September 30, 2014, cash and cash equivalents includes \$374,000 which is available to be used by the Joint Venture to fund future product development initiatives currently under consideration by PSI Parent, PSI and us.

Our determination is that the Joint Venture qualifies as a VIE and that we are the primary beneficiary. We have consolidated the Joint Venture financial statements beginning with the quarter ended March 31, 2010. In Fiscal 2010, we recorded the \$3.6 million payment noted above representing the estimated fair value to acquire the product license as an intangible asset. We currently estimate the expected remaining useful life of the product license to be approximately 12.50 years which we will begin amortizing the cost of intangible asset once product development and commercialization begins. Thus far, the Joint Venture has not generated any revenues and its expenses, including organizational, marketing analysis and preliminary formulations have been absorbed by the respective Joint Venture members. Furthermore, the liabilities and other obligations incurred, if any, by the Joint Venture is without recourse to us and do not create a claim on our general assets.

As previously announced, we are implementing a series of new product development and pre-commercialization initiatives principally in the dietary supplement category. While several of our product development initiatives have advanced, including those specific to the dietary supplement category, our Phusion product development initiatives have not progressed to management’s satisfaction. At this time, management believes that any products embodying the licensed technology to be developed by Phusion will not be available until fiscal 2016 or 2017 at the earliest, and may be more limited than previously forecasted and may encompass fewer products or have limited retail distribution.

ProPhase Labs, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(unaudited)

Note 6 – Investment in a Joint Venture – continued

Pursuant to our established accounting policies, we conducted the Fiscal 2013 annual analysis of our intangible asset as of December 31, 2013 by comparing the estimated fair value of the licensed technology based on the income approach (which utilizes forecasted discounted cash flows to estimate the fair value of the licensed technology) against the then carrying value. As we concluded that, as of December 31, 2013, the fair value according to the income approach exceeded book value, we concluded there was no impairment of the subject intangible asset.

During the third quarter of fiscal 2014, our evaluation of the Company's progress in its new product development pipeline and delays in Phusion product development caused management to reassess projections (including income projections) relied upon in December 2013. Accordingly, management performed an impairment analysis for the period ended September 30, 2014 for the licensed technology. As a consequence of our impairment assessment, we determined that a full impairment occurred of the intangible asset, licensed technology. As a consequence, for the three and nine months ended September 30, 2014 we charged to operations a \$3.6 million impairment charge.

Note 7 – Earnings (Loss) Per Share

Basic earnings (loss) per share is computed by dividing net income or loss attributable to common stockholders by the weighted-average number of shares of our Common Stock outstanding for the period. Diluted earnings (loss) per share reflects the potential dilution that could occur if securities or other contracts to issue Common Stock were exercised or converted into Common Stock or resulted in the issuance of Common Stock that shared in the earnings of the entity. Diluted earnings per share also utilize the treasury stock method which prescribes a theoretical buy-back of shares from the theoretical proceeds of all options and warrants outstanding during the period. Options and warrants outstanding to acquire shares of our Common Stock at September 30, 2014 and 2013 were 1,632,500 and 1,264,000, respectively.

For the nine months ended September 30, 2014 and 2013 dilutive earnings per share is the same as basic earnings per share due to (i) the inclusion of Common Stock, in the form of stock options and warrants ("Common Stock Equivalents"), would have an anti-dilutive effect on the loss per share or (ii) there were no Common Stock Equivalents for the respective period. For the nine months ended September 30, 2014 and 2013, there were 512,182 and 413,285 Common Stock Equivalents, respectively, which were in the money, that were excluded from the earnings per share computation. For the three months ended September 30, 2014, there were 393,260 Common Stock Equivalents which were in the money, that were excluded from the earnings per share computation. For the three months ended September 30, 2013, there were 447,205 Common Stock Equivalents which were in the money, that were included in the earnings per share computation.

ProPhase Labs, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(unaudited)

Note 7 – Earnings (Loss) Per Share – continued

A reconciliation of the applicable numerators and denominators of the income statement periods presented, as reflected in the results of continuing operations, is as follows (in thousands, except per share amounts):

	Three Months Ended September 30, 2014			Three Months Ended September 30, 2013			Nine Months Ended September 30, 2014			Nine Months Ended September 30, 2013		
	Loss	Shares	EPS	Income	Shares	EPS	Loss	Shares	EPS	Loss	Shares	EPS
Basic earnings (loss) per share	\$ (3,216)	18,208	\$ (0.18)	\$ 1,236	15,860	\$ 0.08	\$ (7,158)	17,216	\$ (0.42)	\$ (193)	15,819	\$ (0.01)
Dilutives:												
Options	-	-	-	-	447	-	-	-	-	-	-	-
Diluted income (loss) per share	<u>\$ (3,216)</u>	<u>18,208</u>	<u>\$ (0.18)</u>	<u>\$ 1,236</u>	<u>16,307</u>	<u>\$ 0.08</u>	<u>\$ (7,158)</u>	<u>17,216</u>	<u>\$ (0.42)</u>	<u>\$ (193)</u>	<u>15,819</u>	<u>\$ (0.01)</u>

ProPhase Labs, Inc. and Subsidiaries
Management's Discussion and Analysis of
Financial Condition and Results of Operations

Item 2. Managements Discussion and Analysis of Financial Condition and Results of Operations.

General

ProPhase Labs, Inc. ("we", "us", "ProPhase" or the "Company"), organized under the laws of the State of Nevada, is a manufacturer, marketer and distributor of a diversified range of homeopathic and health products that are offered to the general public. We are also engaged in the research and development of potential over-the-counter ("OTC") drug, natural base health products along with supplements, personal care and cosmeceutical products.

Our primary business is the manufacture, distribution, marketing and sale of OTC cold remedy products to consumers through national chain, regional, specialty and local retail stores. Our flagship brand is Cold-EEZE[®] Cold Remedy and our principal product is Cold-EEZE[®] Cold Remedy zinc gluconate lozenges, proven in clinical studies to reduce the duration and severity of symptoms of the common cold by 42%. In addition to Cold-EEZE[®] Cold Remedy lozenges, we market and distribute non-lozenge forms of our proprietary zinc gluconate formulation, (i) Cold-EEZE[®] Cold Remedy QuickMelts[®] and (ii) Cold-EEZE[®] Cold Remedy Oral Spray. In Fiscal 2014, we expanded our Cold-EEZE[®] Cold Remedy QuickMelts[®] product line and began shipments to retailers in July 2014, Cold-EEZE[®] Cold Remedy Plus Multi-Symptom QuickMelts[®] for cold and flu. Each of our Cold-EEZE[®] Cold Remedy QuickMelts[®] products are based on our proprietary zinc gluconate formulation in combination with certain natural (i) immune system support, (ii) energy, (iii) sleep and relaxation, and/or (iv) cold and flu symptom relieving active ingredients. For the three and nine months ended September 30, 2014 and 2013, our revenues from operations have come principally from our OTC cold remedy products.

Recent Developments

Settlement Agreement

Effective September 4, 2014, we consummated a definitive, global Settlement Agreement ("Settlement Agreement") resolving all of our litigation with certain of the Company's former managers and with certain shareholders. The cases that have been settled include *ProPhase Labs, Inc. v. Quigley, et al.*, Court of Common Pleas of Bucks County, Pennsylvania, Civ. A. No. 2010-08227; *ProPhase Labs, Inc. v. Quigley, et al.*, Court of Common Pleas of Bucks County, Pennsylvania, Civ. A. No. 2011-09815; the appeal filed by the plaintiff in the matter *Quigley v. ProPhase Labs, Inc. & Officers and Directors, et al.*, Court of Common Pleas of Philadelphia County, December Term, 2011, No. 111200409; together with certain ancillary litigation.

The Settlement Agreement amicably resolved these matters and provided, in part, that the parties adverse to the Company in the two Bucks County cases (i) returned to the Company 3,896,764 shares of the Company's Common Stock for which they are listed as the record owners to the Company; and (ii) paid \$440,000 to the Company. In addition, the Company paid \$500,000 to the benefit of one of the defendants and \$37,000 to a third party, to defray certain costs and expenses associated with the Settlement Agreement. The payments received and the payments made pursuant to the Settlement Agreement resulted in a net charge to administration expense of \$97,000 for the three months and nine months ended September 30, 2014. We have also included in accrued expenses at September 30, 2014 \$1.3 million in unpaid litigation costs related to this matter which are expected to be paid prior to December 31, 2014 in a combination of cash and our Common Stock. Pursuant to the Settlement Agreement, the parties also have agreed to (i) a mutual release of all claims, (ii) a standstill agreement whereby, for a period of ten years, the adverse parties will not acquire Company shares, and (iii) the dismissal of all pending litigation involving the Company, its directors and affiliates on the one hand, and the other parties. Management believes the Settlement Agreement will allow the Company and its management team to focus more time, attention and resources towards the continued growth and operations of the Company.

ProPhase Labs, Inc. and Subsidiaries
Management's Discussion and Analysis of
Financial Condition and Results of Operations

Product Development

Our flagship Cold-EEZE[®] Cold Remedy brand has generally outperformed the cough-cold category over the past several years. However, some retailers are reallocating shelf space away from the cough-cold category to other product categories. With cough-cold shelf space at a premium, opportunities in the future to introduce new Cold-EEZE[®] branded products in the cough-cold category may be limited. Therefore, to continue to grow our Company, we are in the process of implementing a series of new product development and pre-commercialization initiatives in the dietary supplement category. While management anticipates the growth potential in this category may be better, the risks associated with introducing new products that do not leverage the Cold-EEZE[®] brand name may be higher. Therefore, no assurance can be made that our new product efforts will be successful. We currently forecast that at least one product in this new category will begin shipping in Fiscal 2015.

Phusion Laboratories, LLC ("Phusion")

As discussed above, we are implementing a series of new product development and pre-commercialization initiatives principally in the dietary supplement category. While several of our product development initiatives have advanced, including those specific to the dietary supplement category, our Phusion product development initiatives have not progressed to management's satisfaction. At this time, management believes that any products embodying the licensed technology to be developed by Phusion will not be available until fiscal 2016 or 2017 at the earliest, may be more limited than previously forecasted and may encompass fewer products or have limited retail distribution.

Pursuant to our established accounting policies, we conducted the Fiscal 2013 annual analysis of our intangible asset as of December 31, 2013 by comparing the estimated fair value of the licensed technology based on the income approach (which utilizes forecasted discounted cash flows to estimate the fair value of the licensed technology) against the then carrying value. As we concluded that, as of December 31, 2013, the fair value according to the income approach exceeded book value, we concluded there was no impairment of the subject intangible asset.

During the third quarter of fiscal 2014, our evaluation of the Company's progress in its new product development pipeline and continued delays in Phusion product development caused management to reassess projections (including income projections) relied upon in December 2013. Accordingly, management performed an impairment analysis for the period ended September 30, 2014 for the licensed technology. As a consequence of our impairment assessment, we determined that a full impairment occurred of the intangible asset, licensed technology. As a consequence, for the three and nine months ended September 30, 2014 we charged to operations a \$3.6 million impairment charge.

Seasonality of the Business

Our sales are derived principally from our OTC cold remedy products. A significant portion of our business is highly seasonal, which causes major variations in operating results from quarter to quarter. The third and fourth quarters generally represent the largest sales volume for our OTC cold remedy products with a corresponding increase in marketing and advertising expenditures designed to promote our products during the Cold Season. In addition, our sales are influenced by and subject to fluctuations in the timing of purchase and the ultimate level of demand for our products which are a function of the timing, length and severity of each cold season. We track health and wellness trends and develop retail promotional strategies to align our production scheduling, inventory management and marketing programs to optimize consumer purchases.

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Financial Condition and Results of Operations

Financial Condition and Results of Operations
Results from Operations for the Three Months Ended September 30, 2014
as Compared to the Three Months Ended September 30, 2013

For the three months ended September 30, 2014, net sales were \$5.1 million as compared to \$5.9 million for the three months ended September 30, 2013. For the three months ended September 30, 2014, net sales of OTC cold remedy products were \$4.9 million as compared to net sales of \$5.1 million for three months ended September 30, 2013. For the three months ended September 30, 2014 and 2013, our contract manufacturing operations generated net sales to third party customers of \$260,000 and \$826,000, respectively.

Cost of sales for the three months ended September 30, 2014 were \$ 1.6 million as compared to \$2.1 million for the three months ended September 30, 2013. For the three months ended September 30, 2014 and the three months ended September 30, 2013, we realized a gross margin of 68.2% and 64.2%, respectively. The increase of 4.0% in gross margin from the prior period is principally due to (i) a decrease in contract manufacturing net sales which carry lower gross margins, (ii) a reduction in the absorption of fixed production costs as a consequence of a decline in net sales, (iii) fluctuations in our product mix shipped from period to period and (iv) the initial expenses incurred as a consequence of a packaging transition to a slightly narrower package of our Cold-EEZE[®] Cold Remedy lozenges at certain retail accounts to obtain additional/new distribution of our Cold-EEZE[®] Cold Remedy QuickMelts[®] products for Fiscal 2014. Gross margins are principally influenced by fluctuations in quarter-to-quarter production volume, fixed production costs and related overhead absorption, raw ingredient costs, inventory mark to market write-downs, if any, retail cooperative incentive promotion and the timing of shipments to customers which are factors of the seasonality of our sales activities and products.

Sales and marketing expense for the three months ended September 30, 2014 was \$875,000 as compared to \$1.1 million for the three months ended September 30, 2013. The decrease in sales and marketing expense for the three months ended September 30, 2014 as compared to the three months ended September 30, 2013 was principally due to a decrease in our marketing expenditures.

Administration expense for the three months ended September 30, 2014 was \$1.9 million as compared to \$1.3 million for the three months ended September 30, 2013. The increase of \$611,000 in administration expense for the three months ended September 30, 2014 as compared to the three months ended September 30, 2013 was principally due to an increase in professional and legal fees related to certain, now resolved, litigation matters.

Research and development costs during the three months ended September 30, 2014 was \$356,000, as compared to \$181,000 for the three months ended September 30, 2013. The increase in research and development costs for the three months ended September 30, 2014 as compared to the three months ended September 30, 2013 was due principally to an increase in the amount and timing of our product development expenditures.

As a consequence of our impairment assessment, we determined that a full impairment occurred of the Phusion intangible asset, licensed technology. As a consequence, for the three months ended September 30, 2014 we charged to operations a \$3.6 million impairment charge.

Interest and other income for the three months ended September 30, 2014 was \$1,000 as compared to zero for the three month periods ended September 30, 2013. Interest expense for the three month periods ended September 30, 2014 and 2013 was \$2,000 and \$3,000, respectively.

As a consequence of the effects of the above, the net loss for the three months ended September 30, 2014, was \$3.2 million, or (\$0.18) per share, as compared to a net income of \$1.2 million, or \$0.08 per share, for the three months ended September 30, 2013.

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Financial Condition and Results of Operations
Results from Operations for the Nine Months Ended September 30, 2014
as Compared to the Nine Months Ended September 30, 2013

For the nine months ended September 30, 2014, net sales were \$13.1 million as compared to \$15.4 million for the nine months ended September 30, 2013. For the nine months ended September 30, 2014, net sales of OTC cold remedy products were \$12.1 million as compared to net sales of \$13.8 million for nine months ended September 30, 2013. The decline in net sales for the nine months ended September 30, 2014 as compared to the nine months ended September 30, 2013 was due principally to (i) the timing of purchases, (ii) the acceptance by retailers of our products, new introductions and existing products in a retail space competitive environment for the cough cold category that we compete within, (iii) decline in the incidence and severity of upper respiratory illness and the common cold and (iv) the ultimate level of demand for our products. For the nine months ended September 30, 2014 and 2013, our contract manufacturing operations generated net sales to third party customers of \$1.0 million and \$1.7 million, respectively.

Cost of sales for the nine months ended September 30, 2014 were \$4.8 million as compared to \$5.3 million for the nine months ended September 30, 2013. For the nine months ended September 30, 2014 and the nine months ended September 30, 2013, we realized a gross margin of 63.2% and 65.4%, respectively. The decrease of 2.2% in gross margin from the prior period is principally due to the net effect of (i) a reduction in the absorption of fixed production costs as a consequence of a decline in net sales, (ii) fluctuations in our product mix shipped from period to period and (iii) the initial expenses incurred as a consequence of a packaging transition to a slightly narrower package of our Cold-EEZE[®] Cold Remedy lozenges at certain retail accounts to obtain additional/new distribution of our Cold-EEZE[®] Cold Remedy QuickMelts[®] products for Fiscal 2014, off set by (iv) a decrease in contract manufacturing net sales which carry lower gross margins. Gross margins are principally influenced by fluctuations in quarter-to-quarter production volume, fixed production costs and related overhead absorption, raw ingredient costs, inventory mark to market write-downs, if any, retail cooperative incentive promotion and the timing of shipments to customers which are factors of the seasonality of our sales activities and products.

Sales and marketing expense for the nine months ended September 30, 2014 was \$4.7 million as compared to \$5.2 million for the nine months ended September 30, 2013. The decrease in sales and marketing expense for the nine months ended September 30, 2014 as compared to the nine months ended September 30, 2013 was principally due to a decrease in our marketing expenditures due to fluctuations in the timing of our marketing programs.

Administration expense for the nine months ended September 30, 2014 was \$6.2 million as compared to \$4.5 million for the nine months ended September 30, 2013. The increase of \$1.7 million in administration expense for the nine months ended September 30, 2014 as compared to the nine months ended September 30, 2013 was principally due to an increase in professional and legal fees related to certain, now resolved, litigation matters.

Research and development costs during the nine months ended September 30, 2014 increased \$321,000 to \$907,000, as compared to \$586,000 for the nine months ended September 30, 2013. The increase in research and development costs for the nine months ended September 30, 2014 as compared to the nine months ended September 30, 2013 was due principally to an increase in the amount and timing of our product development expenditures.

As a consequence of our impairment assessment, we determined that a full impairment occurred of the Phusion intangible asset, licensed technology. As a consequence, for the nine months ended September 30, 2014 we charged to operations a \$3.6 million impairment charge.

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Interest and other income for the nine months ended September 30, 2014 was \$3,000 compared to \$2,000 for the nine month periods ended September 30, 2013. Interest expense for the nine month periods ended September 30, 2014 and 2013 was \$7,000 and \$9,000, respectively.

As a consequence of the effects of the above, the net loss for the nine months ended September 30, 2014, was \$7.2 million, or (\$0.42) per share, as compared to a net loss of \$193,000, or (\$0.01) per share, for the nine months ended September 30, 2013.

Liquidity and Capital Resources

Our aggregate cash and cash equivalents as of September 30, 2014 were \$5.0 million compared to \$1.6 million at December 31, 2013. The increase of \$3.3 million in our cash balance for the nine months ended September 30, 2014 was principally due to the net effect of (i) cash used in operations of \$1.5 million principally as a consequence of the net effect of (a) a decrease of accounts receivable of \$1.3 million, (b) an increase of \$2.1 million to other operating assets and liabilities, offset by (c) an increase to inventory of \$1.7 million, and (d) our net loss of \$7.2 million, inclusive of the \$3.6 million non-cash impairment charge, and, (ii) net proceeds of \$4.9 million from the sale of our Common Stock, offset by (iii) capital expenditures of \$122,000. Our working capital was \$8.3 million and \$6.7 million as of September 30, 2014 and December 31, 2013, respectively.

2012 Equity Line of Credit

On November 21, 2012, we entered into the equity line of credit agreement (such arrangement, the "2012 Equity Line") with Dutchess Opportunity Fund II, LP ("Dutchess") whereby Dutchess committed to purchase, subject to certain restrictions and conditions, up to 2,500,000 shares of our Common Stock, over a period of 36 months from the first trading day following the effectiveness of the registration statement registering the resale of shares purchased by Dutchess pursuant to the 2012 Equity Line. On November 26, 2012, we filed a registration statement with Securities and Exchange Commission ("SEC") to register for sale for up to 2,500,000 shares of our Common Stock and the registration statement was deemed effective by the SEC on December 12, 2012. We amended this registration statement effective May 29, 2014 to withdraw and remove from registration all unissued and unsold shares. We also agreed with Dutchess to terminate the 2012 Equity Line as of May 28, 2014.

We drew on the facility from time to time, as and when we determine appropriate in accordance with the terms and conditions of the 2012 Equity Line. The maximum amount that we were entitled to put to Dutchess in any one draw down notice is the greater of (i) 500% of the average daily volume of our Common Stock traded on the NASDAQ Global Market for the one trading day prior to the date of delivery of the applicable draw down notice, multiplied by the closing price for such trading day, or (ii) \$250,000.

The purchase price under the 2012 Equity Line is set at ninety-five percent (95%) of the lowest daily volume weighted average price ("VWAP") of our Common Stock during the five (5) consecutive trading day period beginning on the date of delivery of the applicable draw down notice. In the event Dutchess received more than a five percent (5%) return on the net sales for a specific put, Dutchess remitted such excess proceeds to us; however, in the event Dutchess received less than a five percent (5%) return on the net sales for a specific put Dutchess had the right to use any such excess proceeds to off-set against the aggregated deficit proceeds.

There were put restrictions applied on days between the draw down notice date and the closing date with respect to that particular put. During such time, we are not allowed to deliver another draw down notice. In addition, Dutchess is not obligated to purchase shares if its total number of shares beneficially held at that time would exceed 9.99% of the number of shares of our Common Stock as determined in accordance with Rule 13d-1(j) of the Securities Exchange Act of 1934, as amended. In addition, we are not permitted to draw on the facility unless there is an effective registration statement to cover the resale of the shares.

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During the period January 1, 2014 through May 23, 2014, we sold an aggregate of 698,207 shares of Common Stock to Dutchess under and pursuant to the 2012 Equity Line and we derived net proceeds of \$1.2 million. The sales of the shares under the 2012 Equity Line were deemed to be exempt from registration under the Securities Act of 1933, as amended in reliance upon Section 4(2) (or Regulation D promulgated thereunder).

2014 Equity Line of Credit

The Company and Dutchess executed a new equity line of credit agreement (such arrangement, the "2014 Equity Line") each dated May 28, 2014 whereby Dutchess committed to purchase, subject to certain restrictions and conditions, up to 3,000,000 shares of the Company's Common Stock, over a period of 36 months from the effectiveness of the registration statement registering the resale of shares purchased by Dutchess pursuant to the Investment Agreement. On May 29, 2014, we filed a registration statement with the SEC to register for sale up to 3,000,000 shares of our Common Stock and the registration statement was declared effective by the SEC on June 4, 2014.

We may in our discretion draw on the facility from time to time, as and when we determine appropriate in accordance with the terms and conditions of the 2014 Equity Line. The maximum number of shares that the Company is entitled to put to Dutchess in any one draw down notice shall not exceed shares with a purchase price of \$500,000, calculated in accordance with the 2014 Equity Line. We may deliver a notice for a subsequent put from time to time, following the one day pricing period for the prior put.

The purchase price shall be set at ninety-five percent (95%) of the volume weighted average price (VWAP) of the Company's Common Stock during the one trading day immediately following our put notice. The Company has the right to withdraw all or any portion of any put, except that portion of the put that has already been sold to a third party, including any portion of a put that is below the minimum acceptable price set forth on the put notice, before the closing. In the event Dutchess receives more than a five percent (5%) return on the net sales for a specific put, Dutchess must remit such excess proceeds to the Company; however, in the Dutchess receives less than a five percent (5%) return on the net sales for a specific put, Dutchess will have the right to deduct from the proceeds of the put amount on the applicable closing date so Dutchess's return will equal five percent (5%).

There are put restrictions applied on days between the draw down notice date and the closing date with respect to that particular put. During such time, the Company shall not be entitled to deliver another draw down notice. In addition, the Investor will not be obligated to purchase shares if Dutchess's total number of shares beneficially held at that time would exceed 4.99% of the number of shares of our Common Stock as determined in accordance with Rule 13d-1(j) of the Securities Exchange Act of 1934, as amended. In addition, we are not permitted to draw on the facility unless there is an effective registration statement to cover the resale of the shares.

During the period June 13, 2014 through September 30, 2014, we sold an aggregate of 2,561,520 shares of our Common Stock to Dutchess under and pursuant to the 2014 Equity Line and we derived net proceeds of \$3.7 million. The sales of the shares under the 2014 Equity Line were deemed to be exempt from registration under the Securities Act of 1933, as amended in reliance upon Section 4(2) (or Regulation D promulgated thereunder). At September 30, 2014, we have 438,480 shares of our Common Stock available for sale, at our discretion, under the terms of the 2014 Equity Line and covered pursuant to a registration statement.

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General

Management believes that its strategy to maintain Cold-EEZE[®] as a recognized brand name, its broader range of products, its adequate manufacturing capacity, together with its current working capital and its available 2014 Equity Line, if exercised, should provide a source of capital to fund normal business operations. Our operations support the current research and development expenditures related to new products. In addition to the funding from operations, it is likely that we will in the short and long term raise capital through the issuance of securities or secure other financing sources to support such product development research, new product acquisitions or a venture investment or acquisition. Such funding through the issuance of equity securities would result in the dilution of current stockholders' ownership in the Company. Should our product development initiatives progress on certain formulations, additional development expenditures may require substantial financial support and may necessitate the consideration of alternative approaches such as licensing, joint venture, or partnership arrangements that we determine will meet our long term goals and objectives. Ultimately, should internal working capital be insufficient and external funding methods or other business arrangements become unattainable, it would likely result in the deferral or abandonment of future development relative to current and prospective product development initiatives and formulations.

Our flagship Cold-EEZE[®] Cold Remedy brand has generally outperformed the cough-cold category over the past several years. However, some retailers are reallocating shelf space away from the cough-cold category to other product categories. With cough-cold shelf space at a premium, opportunities in the future to introduce new Cold-EEZE[®] branded products in the cough-cold category may be limited. Therefore, to continue to grow our Company, we are in the process of implementing a series of new product development and pre-commercialization initiatives in the dietary supplement category. While management anticipates the growth potential in this category may be better, the risks associated with introducing new products that do not leverage the Cold-EEZE[®] Cold Remedy brand name may be higher. Therefore, no assurance can be made that our new product efforts will be successful. We currently forecast that at least one product in this new category will begin shipping in 2015.

Management is not aware of any other trends, events or uncertainties that have or are reasonably likely to have a material negative impact upon our (i) short-term or long-term liquidity, or (ii) net sales or income from continuing operations. Any challenge to our patent rights could have a material adverse effect on our future; however, we are not aware of any condition that would make such an event probable. Our business is subject to seasonal variations thereby impacting liquidity and working capital during the course of our fiscal year.

Management believes that cash generated from operations, along with our current cash balances, will be sufficient to finance working capital and capital expenditure requirements to fund normal business operations for at least the next twelve months. However, we will likely require additional capital to support, among other items, (i) new product introductions, (ii) expansion of our product marketing and promotion activities, (iii) additional research development activities, (iv) further investment in our Joint Venture, (v) venture investments or acquisitions, and/or (vi) support current operations.

To the extent that we do not generate sufficient cash from operations, we may need to incur indebtedness to finance plans for growth. Volatility in the credit markets and the liquidity of major financial institutions may have an adverse effect on our ability to fund our business strategy through borrowings, under either existing or newly created instruments in the public or private markets on terms that we believe to be reasonable, if at all.

Capital Expenditures

Capital expenditures during the remainder of Fiscal 2014 are not expected to be material.

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Off-Balance Sheet Arrangements

It is not our usual business practice to enter into off-balance sheet arrangements such as guarantees on loans and financial commitments and retained interests in assets transferred to an unconsolidated entity for securitization purposes. We have no off-balance sheet arrangements that have, or are reasonably likely to have, a material current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

Certain Risk Factors

Our business is regulated by various agencies of the states and localities where our products are sold. Governmental regulations in foreign countries where we plan to commence or expand sales may prevent or delay entry into a market or prevent or delay the introduction, or require the reformulation of certain of our products. In addition, no prediction can be made as to whether new domestic or foreign legislation regulating our activities will be enacted. Any new legislation could have a material adverse effect on our business, financial condition and operations. Non-compliance with any applicable requirements may subject us or the manufacturers of our products to agency action, including warning letters, fines, product recalls, seizures and injunctions.

The manufacturing, processing, formulation, packaging, labeling and advertising of our cold remedy products are subject to regulation by several federal agencies, including (i) the Food and Drug Administration ("FDA"), (ii) the Federal Trade Commission ("FTC"), (iii) the Consumer Product Safety Commission, (iv) the United States Department of Agriculture, (v) the United States Postal Service, (vi) the United States Environmental Protection Agency and (vii) the United States Occupational Safety and Health Administration.

In addition to OTC and prescription drug products, the FDA regulates the safety, manufacturing, labeling and distribution of dietary supplements, including vitamins, minerals and herbs, food additives, food supplements and cosmetics. The FTC also has overlapping jurisdiction with the FDA to regulate the promotion and advertising of vitamins, OTC drugs, cosmetics and foods. In addition, certain of our OTC cold remedy products are homeopathic remedies which are subject to standards established by the Homeopathic Pharmacopoeia of the United States ("HPUS"). HPUS sets the standards for source, composition and preparation of homeopathic remedies which are officially recognized under the Federal Food, Drug and Cosmetics Act, as amended.

Preclinical development, clinical trials, product manufacturing, labeling, distribution and marketing of potential new products are also subject to federal and state regulation in the United States and other countries. Clinical trials and product marketing and manufacturing are subject to the rigorous review and approval processes of the FDA and foreign regulatory authorities. To obtain approval of a new drug product, a company must demonstrate through adequate and well-controlled clinical trials that the drug product is safe and effective for its intended use. Obtaining FDA and other required regulatory approvals is lengthy and expensive. Typically, obtaining regulatory approval for pharmaceutical products requires substantial resources and takes several years. The length of this process depends on the type, complexity and novelty of the product and the nature of the disease or other indication to be treated. Preclinical studies must comply with FDA regulations. Clinical trials must also comply with FDA regulations to ensure safety of the human subjects in the trial and may require large numbers of test subjects, complex protocols and possibly lengthy follow-up periods. Consequently, satisfaction of government regulations may take several years, may cause delays in introducing potential new products for considerable periods of time and may require imposing costly procedures upon our activities. If regulatory approval of new products is not obtained in a timely manner or not at all, we could be materially adversely affected. Even if regulatory approval of new products is obtained, such approval may impose limitations on the indicated uses for which the products may be marketed which could also materially adversely affect our business, financial condition and future operations.

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We face significant technological risks inherent in developing new products. We may be subject to delays and/or ultimately unable to successfully implement our business plan and strategy to develop and commercialize one or more non-prescription remedies and/or dietary supplements. The commercialization and ultimate product market acceptance is subject to, among other influences, consumer purchasing trends, demand for our product, health and wellness trends, regulatory factors, retail acceptance and overall economic and market conditions. As a consequence, we may suspend or abandon some or all of our proposed new products before they become commercially viable. Even if we develop and obtain approval of a new product, if we cannot successfully commercialize it in a timely manner, our business and financial condition may be materially adversely affected.

We have aligned our operations to focus principally in the research, development, manufacture, marketing and sale of OTC cold remedy and consumer products, natural based health products and other supplement and cosmeceutical products. In addition, we may seek to acquire from third parties or enter into other arrangements with respect to new formulations, ingredients, applications and other products developed by third parties who may be seeking our commercialization, marketing and distribution expertise. There can be no assurance that we will be able to effectuate our business plan successfully or that our revenue growth will continue. In addition, we may not be successful in acquiring or otherwise entering into any new lines of business and, if we are successful in doing so, there can be no assurance that such new business will achieve profitability.

Future revenues, costs, margins, and profits will continue to be influenced by our ability to maintain our manufacturing availability and capacity together with our marketing and distribution capability and the requirements associated with the development of potential OTC drug and other medicinal products in order to continue to compete on a national and international level. Our business development is dependent on continued conformity with government regulations, a reliable information technology system capable of supporting continued growth and continued reliable sources for product and materials to satisfy consumer demand. Many of our competitors have substantially greater capital resources, technical staffs, facilities, marketing resources, product development, distribution and experience than we do. As a consequence, our competitors may have certain advantages, including the ability to allocate greater resources for new product development, marketing and other purposes.

If as part of our annual review of goodwill and intangibles, we are required to write down all or a significant part of our goodwill and/or intangible assets, our net earnings and net worth could be materially adversely affected, which could affect our flexibility to obtain additional financing. In addition, if our assumptions used in preparing our valuations for purposes of impairment testing differ materially from actual future results, we may record impairment charges in the future and our financial results may be materially adversely affected. During the third quarter of fiscal 2014, our evaluation of the Company's progress in its new product development pipeline and delays in Phusion product development caused management to reassess projections (including income projections) relied upon in its December 2013 assessment. Accordingly, management performed an impairment analysis for the period ended September 30, 2014 for certain intangible assets. As a consequence of our impairment assessment, we determined that a full impairment occurred of the intangible asset, licensed technology. As a consequence, for the three and nine months ended September 30, 2014 we charged to operations a \$3.6 million impairment charge.

Readers should carefully review the risk factors described in other sections of this filing, our Annual Report on Form 10-K for the year ended December 31, 2013 as well as in other documents we file from time to time with the SEC.

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Critical Accounting Policies

The preparation of financial statements in conformity with accounting principles generally accepted in the United States (“GAAP”) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates. Our significant accounting policies are described in Note 2 of Notes to Condensed Consolidated Financial Statements included under Item 1 of this Part I. However, certain accounting policies are deemed “critical”, as they require management’s highest degree of judgment, estimates and assumptions. These accounting estimates and disclosures have been discussed with Audit Committee of our Board of Directors. A discussion of our critical accounting policies, the judgments and uncertainties affecting their application and the likelihood that materially different amounts would be reported under different conditions or using different assumptions are as follows:

Revenue Recognition – Sales Allowances

When providing for the appropriate sales returns, allowances, cash discounts and cooperative incentive promotion costs (“Sales Allowances”), we apply a uniform and consistent method for making certain assumptions for estimating these provisions. These estimates and assumptions are based on historical experience, current trends and other factors that management believes to be relevant at the time the financial statements are prepared. Management reviews the accounting policies, assumptions, estimates and judgments on a quarterly basis. Actual results could differ from those estimates.

Our primary product, Cold-EEZE[®] Cold Remedy lozenges, utilizes a proprietary zinc gluconate formulation which has been clinically proven to reduce the severity and duration of common cold symptoms. Factors considered in estimating the appropriate sales returns and allowances for this product include it being (i) a unique product with limited competitors, (ii) competitively priced, (iii) promoted, (iv) unaffected for remaining shelf-life as there is no product expiration date and (v) monitored for inventory levels at major customers and third-party consumption data. In addition to Cold-EEZE[®] Cold Remedy lozenges we market and distribute two additional forms of our proprietary zinc formulation, Cold-EEZE[®] Cold Remedy QuickMelts[®] and Cold-EEZE[®] Cold Remedy Oral Spray. We also manufacture, market and distribute an organic cough drop and a Vitamin C supplement (“Organix[®]”). Each of the Cold-EEZE[®] Cold Remedy Oral Spray and QuickMelts[®] products, and Organix[®] products carry shelf-life expiration dates for which we aggregate such product market experience data and update our sales returns and allowances estimates accordingly. Sales allowances estimates are tracked at the specific customer and product line levels and are tested on an annual historical basis, and reviewed quarterly. Additionally, we monitor current developments by customer, market conditions and any other occurrences that could affect the expected provisions relative to net sales for the period presented.

Our return policy accommodates returns for (i) discontinued products, (ii) store closings and (iii) products that have reached or exceeded their designated expiration date. We do not impose a period of time within which product may be returned. All requests for product returns must be submitted to us for pre-approval. The main components of our returns policy are: (i) we will accept returns that are due to damaged product that is un-saleable and such return request activity fall within an acceptable range, (ii) we will accept returns for products that have reached or exceeded designated expiration dates and (iii) we will accept returns in the event that we discontinue a product provided that the customer will have the right to return only such item that it purchased directly from us. We will not accept return requests pertaining to customer inventory “Overstocking” or “Resets”. We will only accept return requests for product in its intended package configuration. We reserve the right to terminate shipment of product to customers who have made unauthorized deductions contrary to our return policy or pursue other methods of reimbursement. We compensate the customer for authorized returns by means of a credit applied to amounts owed or to be owed and in the case of discontinued product only, also by way of an exchange. We do not have any significant product exchange history.

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We classify product returns into principally three categories, (i) non-routine returns, (ii) obsolete product and (iii) product mix realignment by certain of our customers. "Non-routine" returns are defined as product returned to us as a consequence of unanticipated circumstances principally due to (i) retail store closings or (ii) unexpected poor retail sell through to consumers causing us to discontinue the product. "Obsolete" returns are defined as product returned to us as a consequence of product shelf-life "use by" expiration date. "Product mix realignment" returns are defined as product returned to us due to initiatives by the trade to discontinue purchasing certain of our products. Product mix realignment returns are generally nominal and are frequently related to discontinued or soon to be discontinued products.

As of September 30, 2014, accrued advertising and other allowances included (i) \$2.0 million for estimated future sales returns and (ii) \$1.2 million for cooperative incentive promotion costs. As of December 31, 2013, accrued advertising and other allowances included (i) \$1.5 million for estimated future sales returns and (ii) \$1.3 million for cooperative incentive promotion costs. Additionally, as of September 30, 2014 and December 31, 2013, we included a provision for sales allowances of \$89,000 and \$128,000, respectively, which are reported as a reduction to sales and account receivables.

Income Taxes

As of December 31, 2013, we have net operating loss carry-forwards of approximately \$34.7 million for federal purposes that will expire beginning in Fiscal 2020 through Fiscal 2032. Additionally, there are net operating loss carry-forwards of approximately \$20.4 million for state purposes that will expire beginning in Fiscal 2018 through Fiscal 2032. Until sufficient taxable income to offset the temporary timing differences attributable to operations and the tax deductions attributable to option, warrant and stock are assured, a valuation allowance equaling the total deferred tax asset is being provided. Management believes that this allowance is required due to the uncertainty of realizing these tax benefits in the future. The uncertainty arises largely due to substantial marketing and research and development costs.

Recently Issued Accounting Standards

In July 2013, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2013-11, "Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists" ("ASU 2013-11"). ASU 2013-11 amends Accounting Standards Codification 740, "Income Taxes," to require that in certain cases, an unrecognized tax benefit, or portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward when such items exist in the same taxing jurisdiction. The amendments in this update are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. The amendments should be applied prospectively to all unrecognized tax benefits that exist at the effective date, and retrospective application is permitted. The adoption of ASU 2013-11 did not have a material impact on our consolidated financial position, results from operations or cash flows.

In May 2014, the FASB issued new accounting guidance, namely ASU No. 2014-09, "Revenue from Contracts with Customers", on revenue recognition. The new standard provides for a single five-step model to be applied to all revenue contracts with customers as well as requires additional financial statement disclosures that will enable users to understand the nature, amount, timing and uncertainty of revenue and cash flows relating to customer contracts. Companies have an option to use either a retrospective approach or cumulative effect adjustment approach to implement the standard. There is no option for early adoption. This ASU is effective for fiscal years and interim periods within those years beginning after December 15, 2016. We are currently evaluating the impact of the new guidance on our consolidated financial statements.

ProPhase Labs, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(unaudited)

In June 2014, FASB issued new accounting guidance ASU 2014-12, "Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period". The amendments in this update require that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. Companies should apply existing guidance in ASC 718, "Compensation - Stock Compensation", as it relates to awards with performance conditions that affect vesting to account for such awards. The amendments in this update will be effective as of January 1, 2016. Earlier adoption is permitted. We may apply the amendments in this update either: (1) prospectively to all awards granted or modified after the effective date; or (2) retrospectively to all awards with performance targets that are outstanding as of the beginning of the earliest annual period presented in the financial statements and to all new or modified awards thereafter. If a retrospective transition is adopted, the cumulative effect of applying this update as of the beginning of the earliest annual period presented in the financial statements should be recognized as an adjustment to the opening retained earnings balance at that date. In addition, if a retrospective transition is adopted, we may use hindsight in measuring and recognizing the compensation cost. We are currently assessing the impact of this update, and believe that its adoption on January 1, 2016 will not have a material impact on our consolidated financial statements.

In August 2014, the FASB issued ASU 2014-15, "Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern". The amendments in this update state that in connection with preparing financial statements for each annual and interim reporting period, an entity's management should evaluate whether there are conditions or events that raise substantial doubt about the entity's ability to continue as a going concern within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued, when applicable). The amendments in this update are effective for the annual reporting period beginning after December 15, 2016, and for annual periods and interim periods thereafter. Early application is permitted. The adoption of ASU 2014-15 is not expected to have a material impact on our consolidated financial statements.

Forward-Looking Statements

This Quarterly Report on Form 10-Q contains "forward looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended (the "Securities Act") and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). These forward looking statements relate to future events or our future financial performance and involve known and unknown risks, uncertainties and other factors that may cause our or our industry's actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by the forward-looking statements. Many of these factors are beyond our ability to predict. Given the risks and uncertainties surrounding forward-looking statements, you should not place undue reliance on these statements. Forward-looking statements typically are identified by use of terms such as "anticipate", "believe", "plan", "expect", "intend", "may", "will", "should", "estimate", "predict", "potential", "continue" and similar words although some forward-looking statements are expressed differently. This Report may contain forward-looking statements attributed to third parties relating to their estimates regarding the growth of our markets. You are cautioned that such forward looking statements are not guarantees of future performance and that all forward-looking statements address matters that involve risk and uncertainties, and there are many important risks, uncertainties and other factors that could cause our actual results, levels of activity, performance, achievements and prospects, as well as those of the markets we serve, to differ materially from the forward-looking statements contained in this Report.

ProPhase Labs, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(unaudited)

Such risks and uncertainties include, but are not limited to:

- The ability of our management to successfully implement our business plan and strategy;
- Our ability to fund our operations including the cost and availability of capital and credit;
- Our ability to compete effectively, including our ability to maintain and increase our markets and/or market share in the markets in which we do business;
- Our dependence on sales from our principal product, Cold-EEZE® Cold Remedy, and our ability to successfully develop and commercialize our new products within the cough-cold category or other categories such as dietary supplements;
Changes in our retail and distribution customers strategic business plans including, but not limited to, (i) expansions, mergers, and/or consolidations, (ii) retail shelf space allocations for products within each outlet and in particular the cough/cold category in which we compete, (iii) changes in their private label assortment and (iv) product selections, distribution allocation, merchandising programs and retail pricing of our products as well as competitive products;
- The uncertain length and severity of the general financial and economic downturn, the timing and strength of an economic recovery, if any, and their impacts on our business including demand for our products;
- Our ability to protect our proprietary rights;
- Our continued ability to comply with regulations relating to our current products and any new products we develop, including our ability to effectively respond to changes in laws and regulations or the interpretation thereof including changing market rules and evolving federal, state and regional laws and regulations;
- Potential disruptions in our ability to manufacture our products or our access to raw materials;
- Seasonal fluctuations in demand for our products;
- Our ability to attract, retain and motivate our key employees;
- The ability of Phusion Laboratories, LLC, a 50% owned joint venture, to successfully implement its business plan and strategy to develop and commercialize one or more non-prescription remedies using certain patented and proprietary technology; and
- Other risks identified in this Report.

You should also consider carefully the statements under other sections of this Report and our Annual Report on Form 10-K for the year ended December 31, 2013, which address additional risks that could cause our actual results to differ from those set forth in any forward-looking statements. Our forward-looking statements speak only as the date of this Report. We undertake no obligation to publicly update or review any forward-looking statements, whether as a result of new information, future developments or otherwise.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Like virtually all commercial enterprises, we can be exposed to the risk (“market risk”) that the cash flows to be received or paid relating to certain financial instruments could change as a result of changes in interest rate, exchange rates, commodity prices, equity prices and other market changes.

Our operations are not subject to risks of material foreign currency fluctuations, nor do we use derivative financial instruments in our investment practices. We place our marketable investments in instruments that meet high credit quality standards. We do not expect material losses with respect to our investment portfolio or exposure to market risks associated with interest rates. The impact on our results of one percentage point change in short-term interest rates would not have a material impact on our future earnings, fair value, or cash flows related to investments in cash equivalents or interest-earning marketable securities.

Current economic conditions may cause a decline in business and consumer spending which could adversely affect our business and financial performance including the collection of accounts receivables, realization of inventory and recoverability of assets. In addition, our business and financial performance may be adversely affected by current and future economic conditions, including due to a reduction in the availability of credit, financial market volatility and recession.

Item 4. Controls and Procedures.

Disclosure Controls and Procedures

We maintain disclosure controls and procedures designed to provide reasonable assurance that material information required to be disclosed by us in the reports filed or submitted under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the SEC rules and forms, and that the information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. We performed an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the disclosure controls and procedures as of the end of the period covered by this report. Based on our review, our management, including our Chief Executive Officer and Chief Financial Officer, concluded that the Company’s disclosure controls and procedures were effective at the reasonable assurance level as of the end of the period covered by this Report.

Management’s Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining an adequate system of internal control over financial reporting. Our system of internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America.

Our internal control over financial reporting includes those policies and procedures that:

- pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect our transactions and dispositions of our assets;
- provide reasonable assurance that our transactions are recorded as necessary to permit preparation of our financial statements in accordance with accounting principles generally accepted in the United States of America, and that our receipts and expenditures are being made only in accordance with authorizations of our management and our directors; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of our assets that could have a material effect on the financial statements.

Because of its inherent limitations, a system of internal control over financial reporting can provide only reasonable assurance and may not prevent or detect misstatements. Further, because of changes in conditions, effectiveness of internal controls over financial reporting may vary over time. Our system contains self-monitoring mechanisms, and actions are taken to correct deficiencies as they are identified.

Our management conducted an evaluation of our effectiveness of the system of internal control over financial reporting based on the framework in *Internal Control-Integrated Framework* issued in 1992 by the Committee of Sponsoring Organizations of the Treadway Commission. Based upon our review, our management, including our Chief Executive Officer and Chief Financial Officer, concluded that the Company's internal controls over financial reporting were effective as of September 30, 2014.

Changes in Internal Control Over Financial Reporting

There have been no changes in our internal control over financial reporting during the nine months ended September 30, 2014 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Part II. Other Information

Item 1. Legal Proceedings.

PROPHASE LABS, INC. (formerly THE QUIGLEY CORPORATION) vs. Guy Quigley, Gary Quigley, Scanda Systems Limited, Scanda Systems LTD, Chilesha Holdings LTD, Kevin Brogan, Innerlight Holdings, Inc., George Longo, Graham Brandon AND Pacific Rim Pharmaceuticals LTD, and

GUY QUIGLEY VS. TED KARKUS, ROBERT V. CUDDIHY, JR., MARK BURNETT, MARK LEVENTHAL, MARK FRANK, LOUIS GLECKEL, MD, JAMES McCUBBIN AND PROPHASE LABS, INC. AS A NOMINAL DEFENDANT

See "Management's Discussion and Analysis of Financial Condition and Results of Operations – Recent Developments – Settlement Agreement."

Weisblum vs. PROPHASE LABS, INC.

On May 19, 2014, a putative class action complaint was filed by a consumer (the "Complainant") against the Company, in the United States District Court, Southern District of New York.

The lawsuit, which purports to be brought as a class action on behalf of purchasers of certain products sold by the Company, alleges that the Company engaged in false and misleading marketing, advertising and sales with respect to such products. The Complainant seeks, among other things, certification of the case as a class action, a judgment against the defendants for damages in an amount to be determined by the court and/or jury, and an award of fees and expenses to plaintiffs and their attorneys. The Company believes the claims set forth in the lawsuit are entirely without merit and intends to defend against the lawsuit vigorously. Pre-trial discovery is on-going and at this time, no prediction as to the outcome of this action can be made.

PROPHASE LABS, INC. PROPHASE LABS, INC. FOR THE BENEFIT OF PHUSION LABORATORIES, LLC vs. Phosphagenics, Inc., Phosphagenics, LTD and Phusion Laboratories, LLC as a nominal defendant

On October 17, 2014, we initiated a demand for arbitration with the American Arbitration Association, case number 01-14-0001-7373. This demand for arbitration pertains to our Phusion Labs, LLC (“Phusion”) joint venture and the matter is against Phosphagenics, Inc. and Phosphagenics LTD (collectively known as the “Phosphagenics Entities”). We have raised certain claims based upon the alleged Phosphagenics Entities’ breach of a certain amended and restated licenses agreement for the exploitation of certain intellectual property and, separately, breach of the Phusion joint venture operating agreement as between the Company and the Phosphagenics Entities. This matter is at its preliminary stage and at this time, no prediction as to the outcome of this action can be made.

Item 1A. Risk Factors.

Not applicable

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

During the period January 1, 2014 through May 23, 2014, we sold an aggregate of 698,207 shares of our Common Stock to Dutchess Opportunity Fund II, LP (“Dutchess”) under and pursuant to the 2012 Equity Line with Dutchess dated November 21, 2012, and we derived net proceeds of \$1.2 million. The sales of the shares under the 2012 Equity Line were deemed to be exempt from registration under the Securities Act of 1933, as amended in reliance upon Section 4(2) (or Regulation D promulgated thereunder).

During the period June 13, 2014 through September 30, 2014, we sold an aggregate of 2,561,520 shares of our Common Stock to Dutchess under and pursuant to the 2014 Equity Line and we derived net proceeds of \$3.7 million. The sales of the shares under the 2014 Equity Line were deemed to be exempt from registration under the Securities Act of 1933, as amended in reliance upon Section 4(2) (or Regulation D promulgated thereunder).

Item 3. Defaults Upon Senior Securities.

None

Item 4. Mine Safety Disclosures.

Not applicable

Item 5. Other Information.

None

Item 6. Exhibits

- | | | |
|-----|--------------|--|
| (1) | Exhibit 4.1 | Amended and Restated Rights Agreement by and between ProPhase Labs, Inc. and American Stock Transfer & Trust Company, LLC, dated as of June 18, 2014, which includes the Form of Right Certificate as Exhibit A (incorporated by reference to Exhibit 4.1 of the Company’s Current report on Form 8-K filed on June 19, 2014). |
| (2) | Exhibit 10.1 | Investment Agreement by and between ProPhase Labs, Inc. and Dutchess Opportunity Fund, II, LP, dated as of May 28, 2014 (incorporated by reference to Exhibit 10.1 of the Company’s Current report on Form 8-K filed on May 29, 2014). |
| (3) | Exhibit 10.2 | Registration Rights Agreement by and between ProPhase Labs, Inc. and Dutchess Opportunity Fund, II, LP, dated as of May 28, 2014 (incorporated by reference to Exhibit 10.2 of the Company’s Current report on Form 8-K filed on May 29, 2014). |

- (4) Exhibit 10.3 Letter Agreement by and between ProPhase Labs, Inc. and Dutchess Opportunity Fund, II, LP, dated as of May 28, 2014 (incorporated by reference to Exhibit 10.3 of the Company's Current report on Form 8-K filed on May 29, 2014).
- (5) Exhibit 10.4 Settlement Agreement dated as of August 15, 2014, consummated effective on September 4, 2014 (incorporated by reference to Exhibit 99.3 of the Company's Current report on Form 8-K filed on September 10, 2014).
- (6) Exhibit 31.1 Certification by the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- (7) Exhibit 31.2 Certification by the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- (8) Exhibit 32.1 Certification by the Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- (9) Exhibit 32.2 Certification by the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- (10) 101 INS — XBRL Instance Document
- (11) 101 SCH — XBRL Taxonomy Extension Schema Document
- (12) 101 CAL — XBRL Taxonomy Extension Calculation Linkbase Document
- (13) 101 DEF — XBRL Taxonomy Extension Definition Linkbase Document
- (14) 101 LAB — XBRL Taxonomy Extension Label Linkbase Document
- (15) 101 PRE — XBRL Taxonomy Extension Presentation Linkbase Document

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.

ProPhase Labs, Inc.

By: /s/ Ted Karkus
Ted Karkus
Chairman of the Board and Chief Executive Officer
(Principal Executive Officer)

Date: November 13, 2014

By: /s/ Robert V. Cuddihy, Jr.
Robert V. Cuddihy, Jr.
Chief Operating Officer and Chief Financial Officer
(Principal Accounting and Financial Officer)

Date: November 13, 2014

**OFFICER'S CERTIFICATION PURSUANT TO
RULE 13a-14(a)/15d-14(a) OF THE SECURITIES EXCHANGE ACT OF 1934**

I, Ted Karkus, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of ProPhase Labs, Inc.;
2. Based on my knowledge, this Quarterly 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 Quarterly Report;
3. Based on my knowledge, the financial statements, and other financial information included in this Quarterly 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 Quarterly Report;
4. The registrant's other certifying officer 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 Rule 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 Quarterly 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 Quarterly 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 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: November 13, 2014

By: /s/ Ted Karkus
Ted Karkus
Chairman of the Board and Chief Executive
Officer
(Principal Executive Officer)

**OFFICER'S CERTIFICATION PURSUANT TO
RULE 13a-14(a)/15d-14(a) OF THE SECURITIES EXCHANGE ACT OF 1934**

I, Robert V. Cuddihy, Jr., certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of ProPhase Labs, Inc.;
2. Based on my knowledge, this Quarterly 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 Quarterly Report;
3. Based on my knowledge, the financial statements, and other financial information included in this Quarterly 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 Quarterly Report;
4. The registrant's other certifying officer 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 Rule 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 Quarterly 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 Quarterly 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 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: November 13, 2014

By: /s/ Robert V. Cuddihy, Jr.
Robert V. Cuddihy, Jr.
Chief Operating Officer and
Chief Financial Officer
(Principal Accounting and
Financial Officer)

**PROPHASE LABS, INC.
CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER
PURSUANT TO RULE 13a-14(b) OF THE SECURITIES EXCHANGE ACT OF 1934
AND 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

I, Ted Karkus, Chief Executive Officer of ProPhase Labs, Inc., a Nevada corporation (the "Registrant"), in connection with the Registrant's Quarterly Report on Form 10-Q for the period ended September 30, 2014, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), do hereby represent, warrant and certify, in compliance with Rule 13a-14(b) of the Securities Exchange Act of 1934 and 18 U.S.C Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to the best of my knowledge:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Registrant.

/s/ Ted Karkus
Ted Karkus
Chairman of the Board and Chief Executive Officer
(Principal Executive Officer)
November 13, 2014

**PROPHASE LABS, INC.
CERTIFICATION OF PRINCIPAL FINANCIAL OFFICER
PURSUANT TO RULE 13a-14(b) OF THE SECURITIES EXCHANGE ACT OF 1934
AND 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

I, Robert V. Cuddihy, Jr., Chief Financial Officer of ProPhase Labs, Inc., a Nevada corporation (the "Registrant"), in connection with the Registrant's Quarterly Report on Form 10-Q for the period ended September 30, 2014, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), do hereby represent, warrant and certify, in compliance with Rule 13a-14(b) of the Securities Exchange Act of 1934 and 18 U.S.C Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to the best of my knowledge:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Registrant.

/s/ Robert V. Cuddihy, Jr.
Robert V. Cuddihy, Jr.
Chief Operating Officer and Chief Financial Officer
(Principal Accounting and Financial Officer)
November 13, 2014
