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

FORM 10-Q

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

For the quarterly period ended June 30, 2008

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: 000-23265

SALIX PHARMACEUTICALS, LTD.

(Exact name of Registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

94-3267443
(I.R.S. Employer
Identification No.)

**1700 Perimeter Park Drive
Morrisville, North Carolina 27560**
(Address of principal executive offices, including zip code)

(919) 862-1000
(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 is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

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

Smaller reporting company

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

The number of shares of the Registrant's Common Stock outstanding as of August 1, 2008 was 48,039,577

SALIX PHARMACEUTICALS, LTD.

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PART I. FINANCIAL INFORMATION**Item 1. Financial Statements****SALIX PHARMACEUTICALS, LTD.****CONDENSED CONSOLIDATED BALANCE SHEETS**
(U.S. dollars, in thousands, except share amounts)

	<u>June 30,</u> <u>2008</u> (unaudited)	<u>December 31,</u> <u>2007</u>
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 90,893	\$ 111,272
Accounts receivable, net	37,396	52,208
Inventory, net	24,354	17,676
Prepaid and other current assets	4,804	14,219
Total current assets	<u>157,447</u>	<u>195,375</u>
Property and equipment, net	5,606	5,877
Goodwill	85,371	86,383
Product rights and intangibles, net	101,171	105,713
Other assets	3,644	3,754
Total assets	<u>\$ 353,239</u>	<u>\$ 397,102</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 7,708	\$ 11,889
Accrued liabilities	18,957	20,588
Reserve for product returns, rebates and chargebacks	43,665	52,998
Current portion of capital lease obligations	517	1,009
Total current liabilities	<u>70,847</u>	<u>86,484</u>
Long-term liabilities:		
Borrowings under credit facility	15,000	15,000
Lease incentive obligations	2,586	2,436
Long term portion of capital lease obligations	1,094	612
Total long-term liabilities	<u>18,680</u>	<u>18,048</u>
Stockholders' equity:		
Preferred stock, \$0.001 par value; 5,000,000 shares authorized, issuable in series, none outstanding	—	—
Common stock, \$0.001 par value; 80,000,000 shares authorized, 47,798,474 shares issued and outstanding at June 30, 2008 and 47,708,985 shares issued and outstanding at December 31, 2007	47	47
Additional paid-in capital	399,489	397,261
Accumulated deficit	<u>(135,824)</u>	<u>(104,738)</u>
Total stockholders' equity	<u>263,712</u>	<u>292,570</u>
Total liabilities and stockholders' equity	<u>\$ 353,239</u>	<u>\$ 397,102</u>

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

SALIX PHARMACEUTICALS, LTD.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited)

(U.S. dollars, in thousands, except per share data)

	Three months ended June 30,		Six months ended June 30,	
	2008	2007	2008	2007
Revenues:				
Net product revenues	\$41,071	\$66,678	\$ 75,325	\$126,463
Revenues from collaborative agreements	—	2,500	—	2,500
Total revenues	<u>41,071</u>	<u>69,178</u>	<u>75,325</u>	<u>128,963</u>
Costs and expenses:				
Cost of products sold (excluding amortization of product rights and intangibles of \$2,271 and \$2,271 for the three-month periods ended June 30, 2008 and 2007, and \$4,542 and \$4,084 for the six-month periods ended June 30, 2008 and 2007, respectively)	7,114	13,041	14,370	25,046
Fees and costs related to license agreements	105	1,250	1,605	1,450
Amortization of product rights and intangible assets	2,271	2,271	4,542	4,084
Research and development	15,358	18,988	41,256	40,813
Selling, general and administrative	22,967	21,795	44,144	43,211
Total cost and expenses	<u>47,815</u>	<u>57,345</u>	<u>105,917</u>	<u>114,604</u>
Income (loss) from operations	(6,744)	11,833	(30,592)	14,359
Interest and other income, net	149	302	610	1,202
Income (loss) before provision for income tax	(6,595)	12,135	(29,982)	15,561
Provision for income tax	(494)	(1,898)	(1,104)	(2,480)
Net income (loss)	<u>\$ (7,089)</u>	<u>\$10,237</u>	<u>\$ (31,086)</u>	<u>\$ 13,081</u>
Net income (loss) per share, basic	<u>\$ (0.15)</u>	<u>\$ 0.22</u>	<u>\$ (0.65)</u>	<u>\$ 0.28</u>
Net income (loss) per share, diluted	<u>\$ (0.15)</u>	<u>\$ 0.21</u>	<u>\$ (0.65)</u>	<u>\$ 0.27</u>
Shares used in computing net income (loss) per share, basic	<u>47,763</u>	<u>47,181</u>	<u>47,743</u>	<u>47,137</u>
Shares used in computing net income (loss) per share, diluted	<u>47,763</u>	<u>48,766</u>	<u>47,743</u>	<u>48,724</u>

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

SALIX PHARMACEUTICALS, LTD.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)
(U.S. dollars, in thousands)

	Six months ended June 30,	
	2008	2007
Cash flows from operating activities		
Net income (loss)	\$ (31,086)	\$ 13,081
Adjustments to reconcile net income (loss) to net cash provided (used) by operating activities:		
Depreciation and amortization	6,081	5,004
Loss on disposal of property and equipment	—	16
Stock-based compensation expense	2,088	1,255
Excess tax benefits from stock-based compensation	—	(149)
Changes in operating assets and liabilities:		
Accounts receivable, inventory, prepaid expenses and other assets	18,671	(5,531)
Accounts payable, accrued and other liabilities	(5,662)	(6,078)
Reserve for product returns, rebates and chargebacks	(9,333)	2,623
Net cash provided (used) by operating activities	(19,241)	10,221
Cash flows from investing activities		
Purchases of property and equipment	(665)	(1,559)
Purchase of product rights	—	(55,000)
Net cash used in investing activities	(665)	(56,559)
Cash flows from financing activities		
Borrowings under credit facility	—	15,000
Principal payments on capital lease obligations	(613)	—
Excess tax benefits from stock-based compensation	—	149
Proceeds from issuance of common stock upon exercise of stock options	140	1,142
Net cash provided (used) by financing activities	(473)	16,291
Net decrease in cash and cash equivalents	(20,379)	(30,047)
Cash and cash equivalents at beginning of period	111,272	76,465
Cash and cash equivalents at end of period	\$ 90,893	\$ 46,418

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

SALIX PHARMACEUTICALS, LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2008
(Unaudited)

1. Organization and Basis of Presentation

Salix Pharmaceuticals, Ltd., a Delaware corporation (“Salix” or the “Company”), is a specialty pharmaceutical company dedicated to acquiring, developing and commercializing prescription drugs used in the treatment of a variety of gastrointestinal diseases, which are those affecting the digestive tract.

These consolidated financial statements are stated in United States dollars and are prepared under accounting principles generally accepted in the United States, or GAAP. The accompanying condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated in the consolidation.

The accompanying consolidated financial statements include all adjustments that, in the opinion of management, are necessary for a fair presentation of financial position, results of operations and cash flows. These financial statements should be read in conjunction with “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” or MDA, contained elsewhere in this Quarterly Report, and the audited consolidated financial statements included in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2007 filed with the Securities and Exchange Commission. The results of operations for interim periods are not necessarily indicative of results to be expected for a full year or any future period. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with GAAP have been omitted in accordance with the SEC’s rules and regulations for interim reporting.

2. Revenue Recognition

The Company recognizes revenue in accordance with the SEC’s Staff Accounting Bulletin No. 101, “Revenue Recognition in Financial Statements” as amended by Staff Accounting Bulletin No. 104 (together, “SAB 101”), and FASB Statement No. 48, “Revenue Recognition When Right of Return Exists” (“SFAS 48”). SAB 101 states that revenue should not be recognized until it is realized or realizable and earned. Revenue is realized or realizable and earned when all of the following criteria are met: (a) persuasive evidence of an arrangement exists; (b) delivery has occurred or services have been rendered; (c) the seller’s price to the buyer is fixed or determinable; and (d) collectibility is reasonably assured.

SFAS 48 states that revenue from sales transactions where the buyer has the right to return the product shall be recognized at the time of sale only if (1) the seller’s price to the buyer is substantially fixed or determinable at the date of sale, (2) the buyer has paid the seller, or the buyer is obligated to pay the seller and the obligation is not contingent on resale of the product, (3) the buyer’s obligation to the seller would not be changed in the event of theft or physical destruction or damage of the product, (4) the buyer acquiring the product for resale has economic substance apart from that provided by the seller, (5) the seller does not have significant obligations for future performance to directly bring about resale of the product by the buyer, and (6) the amount of future returns can be reasonably estimated. The Company recognizes revenues for product sales at the time title and risk of loss are transferred to the customer, and the other criteria of SAB 101 and SFAS 48 are satisfied, which is generally at the time products are shipped. The Company’s net product revenue represents the Company’s total revenues less allowances for customer credits, including estimated discounts, rebates, chargebacks, and product returns.

SALIX PHARMACEUTICALS, LTD.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—Continued

The Company establishes allowances for estimated rebates, chargebacks and product returns based on numerous quantitative and qualitative factors, including:

- the number of and specific contractual terms of agreements with customers;
- estimated levels of inventory in the distribution channel;
- historical rebates, chargebacks and returns of products;
- direct communication with customers;
- anticipated introduction of competitive products or generics;
- anticipated pricing strategy changes by the Company and/or its competitors;
- analysis of prescription data gathered by a third-party prescription data provider;
- the impact of changes in state and federal regulations; and
- estimated remaining shelf life of products.

In its analyses, the Company uses prescription data purchased from a third-party data provider to develop estimates of historical inventory channel pull-through. The Company utilizes an internal analysis to compare historical net product shipments to estimated historical prescriptions written. Based on that analysis, it develops an estimate of the quantity of product in the channel which may be subject to various rebate, chargeback and product return exposures. At least quarterly for each product line, the Company prepares an internal estimate of ending inventory units in the distribution channel by adding estimated inventory in the channel at the beginning of the period, plus net product shipments for the period, less estimated prescriptions written for the period. Based on that analysis, the Company develops an estimate of the quantity of product in the channel that might be subject to various rebate, chargeback and product return exposures. This is done for each product line by applying a rate of historical activity for rebates, chargebacks, and product returns, adjusted for relevant quantitative and qualitative factors discussed above, to the potential exposed product estimated to be in the distribution channel. Internal forecasts that are utilized to calculate the estimated number of months in the channel are regularly adjusted based on input from members of the Company's sales, marketing and operations groups. The adjusted forecasts take into account numerous factors including, but not limited to, new product introductions, direct communication with customers and potential product expiry issues.

The Company periodically offers promotional discounts to the Company's existing customer base. These discounts are calculated as a percentage of the current published list price and are treated as off-invoice allowances. Accordingly, the discounts are recorded as a reduction of revenue in the period that the program is offered. In addition to promotional discounts, at the time that the Company implements a price increase, it generally offers its existing customer base an opportunity to purchase a limited quantity of product at the previous list price. Shipments resulting from these programs generally are not in excess of ordinary levels, therefore, the Company recognizes the related revenue upon shipment and includes the shipments in estimating various product related allowances. In the event the Company determines that these shipments represent purchases of inventory in excess of ordinary levels for a given wholesaler, the potential impact on product returns exposure would be specifically evaluated and reflected as a reduction in revenue at the time of such shipments.

Allowances for estimated rebates and chargebacks were \$3.3 million and \$9.3 million as of June 30, 2008 and 2007, respectively. The balance at June 30, 2008 excludes amounts related to Colazal, which are included in the reserve discussed below. These allowances reflect an estimate of the Company's liability for items such as rebates due to various governmental organizations under the Medicare/Medicaid regulations, rebates due to managed care organizations under specific contracts, and chargebacks due to various organizations purchasing our products through federal contracts and/or group purchasing agreements. The Company estimates its liability for rebates and chargebacks at each reporting period based on a methodology of applying quantitative and qualitative assumptions discussed above. Due to the subjectivity of the Company's accrual estimates for rebates and chargebacks, the

SALIX PHARMACEUTICALS, LTD.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—Continued

Company prepares various sensitivity analyses to ensure the Company's final estimate is within a reasonable range and also reviews prior period activity to ensure that the Company's methodology is still reasonable.

Allowances for product returns were \$12.3 million and \$7.4 million as of June 30, 2008 and 2007, respectively. The balance at June 30, 2008 excludes amounts related to Colazal, which are included in the reserve discussed below. These allowances reflect an estimate of the Company's liability for product that may be returned by the original purchaser in accordance with the Company's stated return policy. The Company estimates its liability for product returns at each reporting period based on historical return rates, estimated inventory in the channel and the other factors discussed above. Due to the subjectivity of the Company's accrual estimates for product returns, the Company prepares various sensitivity analyses to ensure the Company's final estimate is within a reasonable range and also reviews prior period activity to ensure that the Company's methodology is still reasonable.

The Company's provision for revenue-reducing items such as rebates, chargebacks, and product returns as a percentage of gross product revenue in the six-month periods ended June 30, 2008 and 2007 was 6.5% and 9.5% for rebates, chargebacks, and discounts, and 7.9% and 2.3%, for product returns, respectively. The percentages for the six-month period ended June 30, 2008 exclude data related to Colazal.

Colazal, the Company's balsalazide disodium capsule, has historically accounted for a majority of the Company's revenue. On December 28, 2007, the Office of Generic Drugs, or OGD, approved three generic balsalazide capsule products. As a result of these generic approvals, the Company expects the future sales of Colazal to be significantly less than historical sales of Colazal. In the fourth quarter of 2007, the Company recorded a \$34.6 million reserve, which was an estimate of the Company's liability for Colazal that may be returned by the original purchaser in accordance with the Company's stated return policy as a result of these generic approvals. At June 30, 2008, this liability was \$28.1 million. This estimate is based on an estimate of Colazal inventory in the channel and related expiration dates of this inventory, estimated erosion of Colazal demand based on the generic approvals and the resulting estimated pull-through of Colazal, actual return activity, estimated chargeback and rebate activity based on price erosion as a result of the generic approvals, and other factors. Due to the subjectivity of this estimate, the Company prepares various sensitivity analyses to ensure the Company's final estimate is within a reasonable range and also reviews prior period activity to ensure that the Company's methodology is still reasonable.

3. *Commitments*

Purchase Order Commitments

At June 30, 2008, the Company had binding purchase order commitments for inventory purchases expected to be delivered over the next 7 months aggregating approximately \$18.6 million.

Potential Milestone Payments

The Company has entered into collaborative agreements with licensors, licensees and others. Pursuant to the terms of these collaborative agreements, the Company is obligated to make one or more payments upon the occurrence of certain milestones. The following is a summary of the material payments that the Company might be required to make under its collaborative agreements if certain milestones are satisfied.

License Agreement with Dr. Falk Pharma GmbH — In July 2002, the Company and Dr. Falk entered into a license agreement which they amended in November 2003 and February 2005. Pursuant to the license agreement, as amended, the Company acquired the rights to develop and market a granulated formulation of mesalamine. The agreement provides that the Company is obligated to make milestone payments up to an aggregate amount of \$11.0 million to Dr. Falk. As of June 30, 2008, the Company had paid \$3.0 million of milestone payments. The remaining milestone payments are contingent upon regulatory approval.

License and Supply Agreement with Norgine B.V. — In December 2005, the Company entered into a license and supply agreement with Norgine for the rights to sell NRL944, a bowel cleansing product the Company now markets in the United States under the trade name MoviPrep. Pursuant to the terms of this agreement, the Company is obligated to make upfront and milestone payments to Norgine that could total up to \$37.0 million over the term of the agreement. As of June 30, 2008, the Company had paid \$17.0 million of milestone payments. The remaining milestone payments are contingent upon reaching sales thresholds.

SALIX PHARMACEUTICALS, LTD.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—Continued

License and Supply Agreement with the Debiopharm Group — In September 2006, the Company acquired the exclusive right to sell, market and distribute vapreotide acetate in the United States. Pursuant to the terms of this agreement, the Company is obligated to make upfront and milestone payments to Debiopharm that could total up to \$14.0 million over the term of the agreement. As of June 30, 2008, the Company had paid \$0.5 million of milestone payments. The remaining milestone payments are contingent upon filing a new drug application, achievement of regulatory approval, and reaching sales thresholds.

License Agreement with Merck & Co, Inc. — In February 2007, the Company entered into a Master Purchase and Sale and License Agreement with Merck, paying Merck \$55.0 million to purchase the U.S. prescription pharmaceutical product rights to Pepcid® Oral Suspension and Diuril® Oral Suspension. Pursuant to the license agreement, the Company is obligated to make additional milestone payments to Merck up to an aggregate of \$6.0 million contingent upon reaching certain sales thresholds during any of the five calendar years beginning in 2007 and ending in 2011.

License Agreement with Wilmington Pharmaceuticals, LLC — In September 2007, the Company entered into an Exclusive Sublicense Agreement with Wilmington Pharmaceuticals to commercialize Metoclopramide — Zydys® worldwide. The agreement provides that the Company is obligated to make upfront and milestone payments up to an aggregate amount of \$8.0 million to Wilmington. As of June 30, 2008, the Company had paid \$1.0 million of these milestone payments. The remaining milestone payments are contingent upon regulatory approval. The Company also loaned Wilmington \$2.0 million which is due on the earlier of December 31, 2009, or regulatory approval.

License Agreement with Dr. Falk Pharma GmbH — In March 2008, the Company entered into a License Agreement with Dr. Falk Pharma GmbH. The agreement provides the Company with an exclusive license to develop and commercialize in the United States Dr. Falk Pharma's budesonide products. The products covered in the License Agreement include U.S. patent-protected budesonide rectal foam and budesonide gastro-resistant capsule, patents for which expire 2015 and 2016, respectively. Pursuant to the license agreement the Company is obligated to make an up-front payment and regulatory milestone payments that could total up to \$23.0 million to Dr. Falk Pharma, with the majority contingent upon achievement of U.S. regulatory approval. As of June 30, 2008, the Company had paid \$1.0 million of these milestone payments.

4. Fair Value of Financial Instruments

The Company adopted SFAS No. 157, "Fair Value Measurements", as of January 1, 2008. SFAS No. 157 establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. SFAS No. 157 applies to all assets and liabilities that are being measured and reported on a fair value basis. SFAS No. 157 requires new disclosure that establishes a framework for measuring fair value in GAAP, and expands disclosure about fair value measurements. This statement enables the reader of the financial statements to assess the inputs used to develop those measurements by establishing a hierarchy for ranking the quality and reliability of the information used to determine fair values. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1 measurements) and the lowest priority to unobservable inputs (level 3 measurements). The three levels of the fair value hierarchy under SFAS No. 157 are described below:

Basis of Fair Value Measurement

- | | |
|---------|---|
| Level 1 | Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities; |
| Level 2 | Quoted prices in markets that are not active or financial instruments for which all significant inputs are observable, either directly or indirectly; |
| Level 3 | Prices or valuations that require inputs that are both significant to the fair value measurement and unobservable. |

A financial instrument's level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Cash equivalents are financial instruments that are subject to SFAS No. 157. These instruments are valued based on level 1 measurements. There is no unrealized gain or loss related to these instruments.

SALIX PHARMACEUTICALS, LTD.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—Continued

The adoption of SFAS No. 157 did not have a material effect on the Company's consolidated financial statements. In February 2008, the FASB issued FASB Staff Position ("FSP") No. FAS 157-2, "Effective Date of FASB Statement No 157", which delays the effective date of SFAS No. 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on at least an annual basis, to years beginning after November 15, 2008. The Company adopted FSP No. FAS 157-2 and deferred the application of SFAS No. 157 to goodwill and product rights and intangibles, net until January 1, 2009.

5. Cash and Cash Equivalents

The Company considers all highly liquid investments with maturities of three months or less from date of purchase to be cash equivalents. The Company maintains its cash and cash equivalents in several different financial instruments with various banks and brokerage houses. This diversification of risk is consistent with Company policy to maintain liquidity and ensure the safety of principal. At June 30, 2008, cash and cash equivalents consisted primarily of demand deposits, overnight investments in Eurodollars, and money market funds at reputable financial institutions and did not consist of any auction rate securities.

6. Inventory

Raw materials, work-in-process and finished goods inventories are stated at the lower of cost (which approximates actual cost on a first-in, first-out cost method) or market value. In evaluating whether inventory is stated at the lower of cost or market, management considers such factors as the amount of inventory on hand and in the distribution channel, estimated time required to sell such inventory, remaining shelf life, and current and expected market conditions, including levels of generic and other competition. Inventory at June 30, 2008 consisted of \$13.4 million of raw materials, \$5.0 million of work-in-process and \$6.7 million of finished goods. \$6.7 million of this inventory is related to balsalazide disodium tablets which are not currently approved for marketing by the US Food and Drug Administration, or FDA. The Company filed a New Drug Application, or NDA, with the FDA in July 2007, and received an approvable letter from the FDA on May 16, 2008. The Company submitted a response to the approvable letter on June 30, 2008. The FDA has up to six months to review the submission so the Company expects a response from the FDA by December 31, 2008.

Inventory at December 31, 2007 consisted of \$7.5 million of raw materials, \$3.6 million of work in process and \$6.6 million of finished goods. As of June 30, 2008, inventory reserves totaling \$0.7 million, compared to \$0.8 million as of December 31, 2007, were recorded to reduce inventories to their net realizable value.

7. Intangible Assets and Goodwill

The Company's intangible assets consist of license agreements, product rights and other identifiable intangible assets, which result from product and business acquisitions. Goodwill represents the excess purchase price over the fair value of assets acquired and liabilities assumed in a business combination.

When the Company makes product acquisitions that include license agreements, product rights and other identifiable intangible assets, it records the purchase price of such intangibles, along with the value of the product related liabilities that it assumes, as intangible assets. The Company allocates the aggregate purchase price to the fair value of the various tangible and intangible assets in order to determine the appropriate carrying value of the acquired assets and then amortizes the cost of the intangible assets as an expense in its consolidated statement of operations over their estimated economic useful life. In accordance with Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", the Company assesses the impairment of identifiable intangible assets whenever events or changes in circumstances indicate that the carrying value may not be recoverable. The Company believes that the following factors could trigger an impairment review: significant underperformance relative to expected historical or projected future operating results; significant changes in the manner of the Company's use of the acquired assets or the strategy for the Company's overall business; and significant negative industry or economic trends.

SALIX PHARMACEUTICALS, LTD.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—Continued

In assessing the recoverability of its intangible assets, the Company must make assumptions regarding estimated future cash flows and other factors. If the estimated undiscounted future cash flows do not exceed the carrying value of the intangible assets, the Company must determine the fair value of the intangible assets. If the fair value of the intangible assets is less than the carrying value, the Company will recognize an impairment loss in an amount equal to the difference. The Company reviews goodwill for impairment on an annual basis, and goodwill and other intangible assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable.

The Company assesses impairment of goodwill on an annual basis in accordance with Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets".

In November 2003, the Company acquired from aaiPharma LLC for \$2.0 million the exclusive right to sell 25, 75 and 100 milligram dosage strengths of azathioprine tablets in North America under the name Azasan. The purchase price was fully allocated to product rights and related intangibles and is being amortized over a period of ten years. Although Azasan does not have any patent protection, the Company believes ten years is an appropriate amortization period based on established product sales history and management's experience. At June 30, 2008, accumulated amortization for the Azasan intangible was \$0.9 million.

In June 2004, the Company acquired the exclusive U.S. rights to Anusol-HC 2.5% (hydrocortisone Cream USP), Anusol-HC 25 mg Suppository (Hydrocortisone Acetate), Proctocort Cream (Hydrocortisone Cream USP) 1% and Proctocort Suppositories (Hydrocortisone Acetate Rectal Suppositories, 30 mg) from King Pharmaceuticals, Inc. for \$13.0 million. The purchase price was fully allocated to product rights and related intangibles and is being amortized over a period of ten years. Although Anusol-HC and Proctocort do not have any patent protection, the Company believes ten years is an appropriate amortization period based on established product sales history and management's experience. At June 30, 2008, accumulated amortization for the King product intangibles was \$5.2 million.

In September 2005, the Company acquired InKine Pharmaceutical Company, Inc. for \$210.0 million. The Company allocated \$74.0 million of the purchase price to in-process research and development, \$9.3 million to net assets acquired and \$37.0 million to specifically identifiable product rights and related intangibles with an ongoing economic benefit to the Company. The Company allocated the remaining \$89.7 million to goodwill, which is not being amortized. The decrease in goodwill over the three-month and six-month periods ended June 30, 2008 and 2007 was a result of the use of net operating income tax loss carryforwards generated by InKine prior to its acquisition by the Company. The InKine product rights and related intangibles are being amortized over an average period of 14 years, which the Company believes is an appropriate amortization period due to the products' patent protection and the estimated economic lives of the product rights and related intangibles. At June 30, 2008, accumulated amortization for the InKine intangibles was \$8.3 million.

In December 2005, the Company entered into a License and Supply Agreement with Norgine B.V., granting Salix the exclusive right to sell a patented-protected, liquid PEG bowel cleansing product, NRL 944, in the United States. Upon execution of the Agreement, the Company made a \$2.0 million payment to Norgine. In August 2006, the Company received Food and Drug Administration marketing approval for NRL 944 under the branded name of MoviPrep, and as a result Salix made a \$15.0 million payment to Norgine. The Company is amortizing the payment over a period of 17.3 years, which the Company believes is an appropriate amortization period due to the product's patent protection and the estimated economic life of the related intangible. At June 30, 2008, accumulated amortization for the MoviPrep intangible was \$1.7 million.

In February 2007, the Company entered into a Master Purchase and Sale and License Agreement with Merck & Co. Inc., to purchase the U.S prescription pharmaceutical product rights to Pepcid Oral Suspension and Diuril Oral Suspension from Merck. The Company paid Merck \$55.0 million at the closing of this transaction. The purchase price was fully allocated to product rights and related intangibles, and is being amortized over a period of 15 years. Although Pepcid and Diuril do not have patent protection, the Company believed 15 years is an appropriate amortization period based on established product history and management experience. At June 30, 2008, accumulated amortization for the Merck products was \$5.0 million.

SALIX PHARMACEUTICALS, LTD.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—Continued

8. Credit Facility

In February 2007, the Company entered into a \$100.0 million revolving credit facility that matures in February 2012. At June 30, 2008, \$15.0 million was outstanding under the credit facility. Virtually all assets of the Company and its subsidiaries collateralize the Company's obligations under the credit facility. Borrowings under the credit facility may be used for working capital, capital expenditures, acquisitions and other general corporate purposes.

The credit facility bears interest at a rate per annum equal to, at the Company's option, either (a) a base rate equal to the higher of (i) the Federal Funds Rate plus 1/2 of 1% and (ii) the Bank of America prime rate, or (b) a Eurodollar rate (based on LIBOR), plus, in each case, a percentage rate that fluctuates, based on the ratio of the Company's funded debt to EBITDA (income before income taxes plus interest expense and depreciation and amortization), from 0.00% to 0.75% for base rate borrowings and 1.00% to 1.75% for Eurodollar rate borrowings.

The credit facility contains various representations, warranties and affirmative, negative and financial covenants customary for financings of this type. The financial covenants include a leverage test and a fixed charge test. The Company was not in compliance with these covenants at June 30, 2008.

In August 2008 the credit facility was amended to waive defaults that may have arisen as a result of the approval of three generic balsalazide capsule products by the Office of Generic Drugs on December 28, 2007 and the credit facility was reduced to \$20 million. The leverage test and fixed charge test were suspended for future periods and the margins added to the interest rate were set at 0.00% for the base rate and 1.00% for the Eurodollar rate, as long as the Company maintains an amount equal to the amount outstanding under the credit facility on deposit with the Administrative Agent of the credit facility and maintains a minimum of \$23 million in cash on its balance sheet. As a result of the execution of the amendment to our credit facility in August 2008, the Company expects to take a \$1.1 million non-cash charge to expense a portion of the unamortized costs related to the credit facility under EITF No. 98-14, "Debtor's Accounting for Changes in Line-of-Credit or Revolving-Debt Arrangements".

9. Research and Development

In accordance with its policy, the Company expenses research and development costs, both internal and externally contracted, as incurred. Effective January 1, 2008 the Company adopted EITF No. 07-3, "Accounting for Nonrefundable Advance Payments for Goods or Services Received for Use in Future Research and Development Activities". Adoption of EITF No. 07-3 did not have a material effect on the Company's consolidated financial position, results of operations or cash flows.

10. Comprehensive Income

SFAS No 130, "Reporting Comprehensive Income", requires that the Company display an amount representing comprehensive income (loss) for the year in a financial statement, which is displayed with the same prominence as other financial statements. The Company elected to present this information in the Consolidated Statements of Stockholders' Equity. Other comprehensive income (loss) includes foreign currency translation gains and losses, as well as any unrealized gains and losses on investments. For the periods presented, there was no other comprehensive income or loss.

11. Stock-Based Compensation

At June 30, 2008, the Company had one active share-based compensation plan, the 2005 Stock Plan, allowing for the issuance of stock options and restricted shares. Awards granted from this plan are granted at the fair market value on the date of grant and vest over periods ranging from one to four years.

Starting in 2006, the Company began issuing restricted shares to employees, executive officers and directors of the Company. The restrictions on the restricted stock granted to date to employees and executive officers of the Company, generally lapse 25% annually over four years. For board members of the Company, restrictions on annual grants lapse 100% after one year and restrictions on the initial grant made to a new director of the Board lapse 33% annually over 3 years. The Company estimates the fair value of the restricted stock using an assumed forfeiture rate

SALIX PHARMACEUTICALS, LTD.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—Continued

of 7.7% and expenses this fair value on a straight-line basis over the period during which the restrictions lapse. Each quarter, the Company adjusts this fair value based on actual forfeitures. For the six-month periods ended June 30, 2008 and 2007 the Company recognized \$2.1 million and \$1.3 million, respectively, in share based-compensation expense related to the restricted shares. For the three-month periods ended June 30, 2008 and 2007 the Company recognized \$1.1 million and \$0.7 million, respectively, in share based-compensation expense related to the restricted shares. As of June 30, 2008, the total amount of unrecognized compensation cost related to nonvested restricted stock awards, to be recognized as expense subsequent to June 30, 2008, was approximately \$15.4 million, and the related weighted-average period over which it is expected to be recognized is approximately 2.75 years.

Aggregate stock plan activity is as follows:

	Total Shares Available For Grant	Stock Options		Restricted Shares		Stock Options and Restricted Shares	
		Number	Weighted Average Price	Number Subject to Issuance	Weighted Average Price	Number	Weighted Average Price
Balance at December 31, 2007	611,253	5,214,529	\$ 14.03	1,123,199	\$ 12.68	6,337,728	\$ 13.80
Granted	(926,519)	—	—	926,519	\$ 7.00	926,519	\$ 7.00
Exercised	—	(52,214)	\$ 2.67	—	—	(52,214)	\$ 2.67
Vested	—	—	—	(37,275)	\$ 13.76	(37,275)	\$ 13.76
Additional shares authorized	837,311	—	—	—	—	—	—
Canceled	190,282	(367,190)	\$ 17.98	(77,194)	\$ 13.04	(444,384)	\$ 17.12
Balance at June 30, 2008	<u>712,327</u>	<u>4,795,125</u>	<u>\$ 13.86</u>	<u>1,935,249</u>	<u>\$ 9.92</u>	<u>6,730,374</u>	<u>\$ 12.73</u>

For the six-month period ended June 30, 2008, 0.1 million shares of the Company's outstanding stock at a value of \$0.4 million were issued upon the exercise of options. The Company recognized no share-based compensation expense for stock options during the six-month period ended June 30, 2008, nor any income tax benefit. The total intrinsic value of options exercised during the six-month period ended June 30, 2008 was \$0.3 million. As of June 30, 2008, there was no unrecognized compensation cost as all stock options were fully vested. Cash received from stock option exercises was \$0.1 million during the six-month period ended June 30, 2008.

12. Income Taxes

The Company provides for income taxes under the liability method in accordance with SFAS No. 109, "Accounting for Income Taxes". This approach requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of differences between the tax basis of assets or liabilities and their carrying amounts in the consolidated financial statements. The Company provides a valuation allowance for deferred tax assets if it is more likely than not that these items will either expire before the Company is able to realize their benefit or if future deductibility is uncertain.

In June 2006, the FASB issued FASB Interpretation No. 48 "Accounting for Uncertainty in Income Taxes" ("FIN 48"), which is an interpretation of SFAS 109 "Accounting for Income Taxes". This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return and also provides guidance on derecognizing, classification, interest and penalties, accounting in interim periods, disclosure and transition.

On January 1, 2007, the Company adopted the provisions of FIN 48. As a result of applying the provisions of FIN 48, the Company recognized an increase of \$2.4 million in the liability for unrecognized tax benefits and a reduction in the valuation allowance as of January 1, 2007, for the same amount. The unrecognized tax benefits as of June 30, 2008 relate to federal tax credit carryforwards. The Company continues to fully recognize its tax benefits which are offset by a valuation allowance to the extent that it is more likely than not that the deferred tax assets will not be realized. The Company does not expect any significant changes in its unrecognized tax benefits for the next twelve months.

SALIX PHARMACEUTICALS, LTD.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—Continued

The Company files a consolidated U.S. federal income tax return and consolidated and separate company income tax returns in many U.S. state jurisdictions. Generally, the Company is no longer subject to federal and state income tax examinations by U.S. tax authorities for years prior to 1993. The Internal Revenue Service has commenced an examination of the Company's U.S. income tax return for 2005. The Company anticipates that any adjustments as a result of this examination would not be material to its financial position.

The Company recognizes any interest accrued related to unrecognized tax benefits in interest expense and penalties in operating expenses. During the six-month periods ended June 30, 2008 and 2007, there was no such interest or penalties.

The provision for income taxes reflects the Company's estimate of the effective tax rate expected to be applicable for the full fiscal year. The Company's effective tax rate for the three-month and six-month periods ended June 30, 2008 was (7.5)% and (3.7)%, respectively, due to the utilization of acquisition-related deferred tax assets. The Company's effective tax rate for the three-month and six-month periods ended June 30, 2007 was 15.6% and 15.9%, respectively, due to the utilization of net operating loss carry-forwards. The Company re-evaluates this estimate each quarter based on the Company's estimated tax expense for the year.

13. Net Income per Share

The Company computes net income (loss) per share in accordance with SFAS No. 128, "Earnings Per Share" ("SFAS 128"). Under the provisions of SFAS 128, basic net income (loss) per share is computed by dividing net income (loss) by the weighted average number of common shares outstanding. Diluted net income (loss) per share is computed by dividing net income (loss) by the weighted average number of common shares and dilutive common share equivalents then outstanding. Common share equivalents consist of the incremental common shares issuable upon the exercise of stock options and the impact of vested restricted stock grants.

The following table reconciles the numerator and denominator used to calculate diluted net income (loss) per share (in thousands):

	Three months ended		Six months ended	
	June 30,		June 30,	
	2008	2007	2008	2007
Numerator:				
Net income (loss)	\$(7,089)	\$10,237	\$(31,086)	\$13,081
Denominator:				
Weighted average common shares, basic	47,763	47,181	47,743	47,137
Dilutive effect of stock options	—	1,295	—	1,327
Dilutive effect of restricted stock	—	290	—	260
Weighted average common shares, diluted	<u>47,763</u>	<u>48,766</u>	<u>47,743</u>	<u>48,724</u>

For the three-month and six-month periods ended June 30, 2008, weighted average common shares, diluted are equal to weighted average common shares, basic, because inclusion of the effect of 636,986 and 608,654 shares of restricted stock and stock options, respectively, would have an anti-dilutive effect due to the net loss during that period. For the six-month periods ended June 30, 2008 and 2007, there were 4,874,555 and 3,878,008, respectively, potential common shares outstanding that were excluded from the diluted net income per share calculation because their effect would have been anti-dilutive. For the three-month periods ended June 30, 2008 and 2007, there were 4,862,181 and 3,779,529, respectively, potential common shares outstanding that were excluded from the diluted net income per share calculation because their effect would have been anti-dilutive.

SALIX PHARMACEUTICALS, LTD.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—Continued

14. Segment Reporting

The Company operates in a single industry acquiring, developing and commercializing prescription drugs used in the treatment of a variety of gastrointestinal diseases, which are those affecting the digestive tract. Accordingly, the Company's business is classified as a single reportable segment.

The following table presents net product revenues by product (in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2008	2007	2008	2007
Colazal	\$ —	\$31,199	\$ 1,345	\$ 61,252
Xifaxan	18,018	15,776	34,759	31,176
Purgatives – Moviprep/OsmoPrep/Visicol	15,707	11,410	25,975	22,447
Other – Anusol/Azasan/Diuril/Pepcid/Proctocort	7,346	8,293	13,246	11,588
Net product revenues	<u>\$41,071</u>	<u>\$66,678</u>	<u>\$75,325</u>	<u>\$126,463</u>

15. Recently Issued Accounting Pronouncements

In December 2007, the FASB issued SFAS No. 141 (revised 2007) "Business Combinations" ("SFAS 141R"). SFAS 141R is effective for fiscal years beginning on or after December 15, 2008, which means that we will adopt SFAS 141R in our fiscal year 2009. SFAS 141R replaces SFAS 141 "Business Combinations" and requires that the acquisition method of accounting (which SFAS 141 called the purchase method) be used for all business combinations, as well as for an acquirer to be identified for each business combination. SFAS 141R establishes principles and requirements for how the acquirer: (i) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree; (ii) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and (iii) determines what information to disclose to enable users of financial statements to evaluate the nature and financial effects of the business combination. The Company is currently evaluating the impact of adoption of SFAS 141R on the Company's consolidated financial position, results of operations and cash flows.

In December 2007, the FASB issued SFAS No. 160 "Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51" ("SFAS 160"). SFAS 160 is effective for fiscal years beginning on or after December 15, 2008, which means that we will adopt SFAS 160 in our fiscal year 2009. This statement amends ARB 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS 160 changes accounting and reporting for minority interests, which will be recharacterized as noncontrolling interests and classified as a component of equity in the Consolidated Financial Statements. SFAS 160 requires retroactive adoption of the presentation and disclosure requirements for existing minority interests. All other requirements of SFAS 160 shall be applied prospectively. The Company does not believe the adoption of SFAS 160 will have a material impact on the Company's consolidated financial position, results of operations and cash flows.

In February 2007, the FASB issued SFAS No. 159 "The Fair Value Option for Financial Assets and Financial Liabilities" ("SFAS 159"). SFAS 159 permits entities to choose, at specified election dates, to measure eligible items at fair value (the "Fair Value Option"). Unrealized gains and losses on items for which the Fair Value Option has been elected are reported in earnings. The Fair Value Option is applied instrument by instrument (with certain exceptions), is irrevocable (unless a new election date occurs) and is applied only to an entire instrument. The effect of the first remeasurement to fair value is reported as a cumulative-effect adjustment to the opening balance of retained earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007. The Company has not elected to apply SFAS 159 to any assets or liabilities, therefore the adoption of SFAS 159 on January 1, 2008 did not have a material impact on the Company's consolidated financial position, results of operations or cash flows.

SALIX PHARMACEUTICALS, LTD.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—Continued

16. Subsequent Event

On July 25, 2008 the Company received a notice of Paragraph IV Certification on behalf of Novel Laboratories, Inc. advising of the submission of an Abbreviated New Drug Application, or ANDA, for OsmoPrep. A Paragraph IV challenge is where the ANDA includes certification by the generic company that, in the generic company's opinion, its generic product does not infringe on the listed patents or that those patents are not enforceable. The Company is currently reviewing the notification and evaluating its options. The Company has until on or about September 8, 2008 to assess whether to file a patent infringement action against Novel. In the event a suit is filed, the FDA will delay approval of the ANDA until the earlier of the resolution of the suit or 30 months.

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

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These forward-looking statements are subject to risks and uncertainties, including those set forth under "Part I. Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2007, and "Cautionary Statement" included in this "Part I. Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations" and elsewhere in this report, that could cause actual results to differ materially from historical results or anticipated results. The following discussion should be read in conjunction with our Condensed Consolidated Financial Statements and notes thereto included elsewhere in this report.

Overview

We are a specialty pharmaceutical company dedicated to acquiring, developing and commercializing prescription drugs used in the treatment of a variety of gastrointestinal diseases, which are those affecting the digestive tract. Our strategy is to:

- identify and acquire rights to products that we believe have potential for near-term regulatory approval or are already approved;
- apply our regulatory, product development, and sales and marketing expertise to commercialize these products; and
- use our 150-member specialty sales and marketing team focused on high-prescribing U.S. gastroenterologists to sell our products.

Our current products demonstrate our ability to execute this strategy. As of June 30, 2008, our primary products were:

- XIFAXAN® (rifaximin) Tablets 200 mg;
- OSMOPREP® (sodium phosphate monobasic monohydrate, USP and sodium phosphate dibasic anhydrous, USP) Tablets;
- MOVIPREP® (PEG 3350, Sodium Sulfate, Sodium Chloride, Potassium Chloride, Sodium Ascorbate and Ascorbic Acid for Oral Solution);
- VISICOL® (sodium phosphate monobasic monohydrate, USP, and sodium phosphate dibasic anhydrous, USP) Tablets;
- AZASAN® Azathioprine Tablets, USP, 75/100 mg;
- ANUSOL-HC® 2.5% (Hydrocortisone Cream, USP), ANUSOL-HC® 25 mg Suppository (Hydrocortisone Acetate);
- PROCTOCORT® Cream (Hydrocortisone Cream, USP) 1% and PROCTOCORT® Suppository (Hydrocortisone Acetate Rectal Suppositories) 30 mg;
- PEPCID® (famotidine) for Oral Suspension;
- Oral Suspension DIURIL® (Chlorothiazide); and
- COLAZAL® (balsalazide disodium) Capsules 750 mg.

We currently market our products, and intend, if approved by the FDA, to market future products, to U.S. gastroenterologists and other physician targets through our own direct sales force. We enter into distribution relationships outside the United States and in certain markets in the United States where a larger sales organization is appropriate. Currently, our sales and marketing staff consists of approximately 150 people.

We generate revenue primarily by selling our products, namely prescription drugs, to pharmaceutical wholesalers. These direct customers resell and distribute our products to and through pharmacies to patients who have had our products prescribed by doctors. Because demand for our products originates with doctors, our sales force calls on high-prescribing specialists, primarily gastroenterologists, and we monitor new and total prescriptions for our products as key performance indicators for our business.

Prescriptions result in our products being used by patients, requiring our direct customers to purchase more products to replenish their inventory. However, our revenue might fluctuate from quarter to quarter due to other factors, such as increased buying by wholesalers in anticipation of a price increase or because of the introduction of new products. Revenue could be less than anticipated in subsequent quarters as wholesalers' increased inventory is used up. For example, wholesalers made initial stocking purchases of OsmoPrep when it was launched in second quarter 2006 and MoviPrep when it was launched in the third quarter of 2006.

In December 2000, we established our own field sales force to market Colazal in the United States. Currently, this sales force has approximately 100 sales representatives in the field and markets our currently approved products. Although the creation of an independent sales organization involved substantial costs, we believe that the financial returns from our direct product sales have been and will continue to be more favorable to us than those from the indirect sale of products through marketing partners. In addition, we intend to enter into distribution relationships outside the United States and in markets where a larger sales organization is appropriate.

Our primary product candidates under development and their status is as follows:

<u>Compound</u>	<u>Indication</u>	<u>Status</u>
Balsalazide disodium tablets	Ulcerative colitis	Approvable letter received
Granulated mesalamine	Ulcerative colitis	NDA filed
Rifaximin	Travelers' diarrhea prevention	Phase III
Rifaximin	Irritable bowel syndrome	Phase III
Rifaximin	Hepatic encephalopathy	Phase III
Rifaximin	<i>C. difficile</i> — associated diarrhea	Phase III
Vapreotide acetate	Acute esophageal variceal bleeding	Confirmatory Phase III completed
Metoclopramide — Zydys®	gastroesophageal reflux and gastroparesis	NDA filed

On May 16, 2008 we received an approvable letter from the FDA for balsalazide disodium tablets. We submitted a response to the approvable letter on June 30, 2008. The FDA has up to six months to review the submission so we expect a response from the FDA by December 31, 2008.

Critical Accounting Policies

In our Annual Report on Form 10-K for the fiscal year ended December 31, 2007, we identified our most critical accounting policies and estimates upon which our financial status depends as those relating to revenue recognition, allowance for product returns, allowance for rebates and coupons, inventory, intangible assets and goodwill, allowance for uncollectible accounts, investments, and research and development expenses. We reviewed our policies and determined that those policies remained our most critical accounting policies for the six-month period ended June 30, 2008. We did not make any changes in those policies during the quarter.

We recognize revenue in accordance with the SEC’s Staff Accounting Bulletin No. 101, “Revenue Recognition in Financial Statements” as amended by Staff Accounting Bulletin No. 104 (together, “SAB 101”), and FASB Statement No. 48, “Revenue Recognition When Right of Return Exists” (“SFAS 48”). SAB 101 states that revenue should not be recognized until it is realized or realizable and earned. Revenue is realized or realizable and earned when all of the following criteria are met: (a) persuasive evidence of an arrangement exists; (b) delivery has occurred or services have been rendered; (c) the seller’s price to the buyer is fixed and determinable; and (d) collectibility is reasonably assured.

SFAS 48 states that revenue from sales transactions where the buyer has the right to return the product shall be recognized at the time of sale only if (1) the seller’s price to the buyer is substantially fixed or determinable at the date of sale, (2) the buyer has paid the seller, or the buyer is obligated to pay the seller and the obligation is not contingent on resale of the product, (3) the buyer’s obligation to the seller would not be changed in the event of theft or physical destruction or damage of the product, (4) the buyer acquiring the product for resale has economic substance apart from that provided by the seller, (5) the seller does not have significant obligations for future performance to directly bring about resale of the product by the buyer, and (6) the amount of future returns can be reasonably estimated. We recognize revenues for product sales at the time title and risk of loss are transferred to the customer, and the other criteria of SAB 101 and SFAS 48 are satisfied, which is generally at the time products are shipped. Our net product revenue represents our total revenues less allowances for customer credits, including estimated discounts, rebates, chargebacks, and product returns.

We establish allowances for estimated rebates, chargebacks and product returns based on numerous quantitative and qualitative factors, including:

- the number of and specific contractual terms of agreements with customers;
- estimated levels of inventory in the distribution channel;
- historical rebates, chargebacks and returns of products;
- direct communication with customers;
- anticipated introduction of competitive products or generics;
- anticipated pricing strategy changes by us and/or our competitors;
- analysis of prescription data gathered by a third-party prescription data provider;
- the impact of changes in state and federal regulations; and
- estimated remaining shelf life of products.

In our analyses, we use prescription data purchased from a third-party data provider to develop estimates of historical inventory channel pull-through. We utilize an internal analysis to compare historical net product shipments to estimated historical prescriptions written. Based on that analysis, we develop an estimate of the quantity of product in the channel which may be subject to various rebate, chargeback and product return exposures. At least quarterly for each product line, we prepare an internal estimate of ending inventory units in the distribution channel by adding estimated inventory in the channel at the beginning of the period, plus net product shipments for the period, less estimated prescriptions written for the period. Based on that analysis, we develop an estimate of the quantity of product in the channel that might be subject to various rebate, chargeback and product return exposures. This is done for each product line by applying a rate of historical activity for rebates, chargebacks and product returns, adjusted for relevant quantitative and qualitative factors discussed above, to the potential exposed product estimated to be in the distribution channel. Internal forecasts that are utilized to calculate the estimated number of months in the channel are regularly adjusted based on input from members of our sales, marketing and operations groups. The adjusted forecasts take into account numerous factors including, but not limited to, new product introductions, direct communication with customers and potential product expiry issues.

Consistent with industry practice, we periodically offer promotional discounts to our existing customer base. These discounts are calculated as a percentage of the current published list price and are treated as off-invoice allowances. Accordingly, the discounts are recorded as a reduction of revenue in the period that the program is offered. In addition to promotional discounts, at the time that we implement a price increase, we generally offer our existing customer base an opportunity to purchase a limited quantity of product at the previous list price. Shipments resulting from these programs generally are not in excess of ordinary levels, therefore, we recognize the related revenue upon shipment and include the shipments in estimating our various product related allowances. In the event we determine that these shipments represent purchases of inventory in excess of ordinary levels for a given wholesaler, the potential impact on product returns exposure would be specifically evaluated and reflected as a reduction in revenue at the time of such shipments.

Allowances for estimated rebates and chargebacks were \$3.3 million and \$9.3 million as of June 30, 2008 and 2007, respectively. The balance at June 30, 2008 excludes amounts related to Colazal, which are included in the reserve discussed below. These allowances reflect an estimate of our liability for items such as rebates due to various governmental organizations under the Medicare/Medicaid regulations, rebates due to managed care organizations under specific contracts, and chargebacks due to various organizations purchasing certain of our products through federal contracts and/or group purchasing agreements. We estimate our liability for rebates and chargebacks at each reporting period based on a methodology of applying the relevant quantitative and qualitative assumptions discussed above. Due to the subjectivity of our accrual estimates for rebates and chargebacks, we prepare various sensitivity analyses to ensure our final estimate is within a reasonable range and also review prior period activity to ensure that our methodology is still reasonable. Had a change in one or more variables in the analyses (utilization rates, contract modifications, etc.) resulted in an additional percentage point change in the trailing average of estimated chargeback and rebate activity in 2007, we would have recorded an adjustment to revenues of approximately \$3.1 million, or 1.0%, for the year.

Allowances for product returns were \$12.3 million and \$7.4 million as of June 30, 2008 and 2007, respectively. The balance at June 30, 2008 excludes amounts related to Colazal, which are included in the reserve discussed below. These allowances reflect an estimate of our liability for product that may be returned by the original purchaser in accordance with our stated return policy. We estimate our liability for product returns at each reporting period based on historical return rates, the estimated inventory in the channel, and the other factors discussed above. Due to the subjectivity of our accrual estimates for product returns, we prepare various sensitivity analyses to ensure our final estimate is within a reasonable range and also review prior period activity to ensure that our methodology is still reasonable. A change in assumptions that resulted in a 10% change in forecasted return rates for all products other than Colazal would have resulted in a change in total product returns liability at December 31, 2007 of approximately \$4.5 million and a corresponding change in 2007 net product revenue of less than 2.0%.

Colazal, our balsalazide disodium capsule, has historically accounted for a majority of the Company's revenue. On December 28, 2007, the Office of Generic Drugs, or OGD, approved three generic balsalazide capsule products. As a result of these generic approvals, the Company expects the future sales of Colazal to be significantly less than historical sales of Colazal. In the fourth quarter of 2007, the Company recorded a \$34.6 million reserve, which is an estimate of the Company's liability for Colazal that may be returned by the original purchaser in accordance with the Company's stated return policy as a result of these generic approvals. At June 30, 2008 the reserve balance was \$28.1 million. This estimate was developed based on the following estimates:

- our estimate of the quantity and expiration dates of Colazal inventory in the distribution channel based on historical net product shipments less estimated historical prescriptions written;
- our estimate of future demand for Colazal based on the actual erosion of product demand for several comparable products that were previously genericized, and the most recent demand for Colazal prior to the generic approvals;
- the actual demand for Colazal experienced during 2008 subsequent to the generic approvals;
- our estimate of potential cannibalization of Colazal demand by our 1100mg balsalazide tablets if approved by the FDA;

- our estimate of chargeback and rebate activity based on price erosion as a result of the generic approvals;
- our estimate of the generic market that will be obtained by Watson, our authorized generic distributor; and
- other relevant factors.

Due to the subjectivity of this estimate, the Company prepares various sensitivity analyses to ensure the Company's final estimate is within a reasonable range. A change in assumptions that resulted in a 10% change in the quantity of Colazal inventory in the distribution channel would have resulted in a change in the Colazal return reserve of approximately \$8.2 million and a corresponding change in 2007 net product revenue of approximately 3.5%. A change in assumptions that resulted in a 10% change in the estimated future demand of Colazal would have resulted in a change in the Colazal return reserve of approximately \$2.6 million and a corresponding change in 2007 net product revenue of approximately 1.1%.

For the six-month periods ended June 30, 2008 and 2007, our absolute exposure for rebates, chargebacks and product returns has grown primarily as a result of increased sales of our existing products, the approval of new products and the acquisition of products. Accordingly, reductions to revenue and corresponding increases to allowance accounts have likewise increased. The estimated exposure to these revenue-reducing items as a percentage of gross product revenue in the six-month periods ended June 30, 2008 and 2007 was 6.5% and 9.5% for rebates, chargebacks and discounts and was 7.9% and 3.3% for product returns, respectively. The percentages for the six-month period ended June 30, 2008 exclude data related to Colazal.

Results of Operations

Three-month and Six-month Periods Ended June 30, 2008 and 2007

Revenues

The following table summarizes net product revenues by product for the three-month and six-month periods ended June 30 (in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2008	2007	2008	2007
Colazal	\$ —	\$31,199	\$ 1,345	\$ 61,252
<i>% of net product revenues</i>	<i>0 %</i>	<i>47 %</i>	<i>2 %</i>	<i>48 %</i>
Xifaxan	18,018	15,776	34,759	31,176
<i>% of net product revenues</i>	<i>44 %</i>	<i>24 %</i>	<i>46 %</i>	<i>25 %</i>
Purgatives – Moviprep/OsmoPrep/Visicol	15,707	11,410	25,975	22,447
<i>% of net product revenues</i>	<i>38 %</i>	<i>17 %</i>	<i>34 %</i>	<i>18 %</i>
Other – Anusol/Azasan/Diuril/Pepcid/Proctocort	7,346	8,293	13,246	11,588
<i>% of net product revenues</i>	<i>18 %</i>	<i>12 %</i>	<i>18 %</i>	<i>9 %</i>
Net product revenues	<u>\$41,071</u>	<u>\$66,678</u>	<u>\$75,325</u>	<u>\$126,463</u>

Net product revenues for the three-month period ended June 30, 2008 were \$41.1 million, compared to \$66.7 million for the corresponding three-month period in 2007, a 38% decrease. The net product revenue decrease for the three-month period ended June 30, 2008 compared to the three-month period ended June 30, 2007 was primarily due to a decrease in sales of Colazal as a result of the approval of three generic balsalazide capsule products on December 28, 2007, and slightly lower sales of Pepcid, partially offset by:

- increased unit sales of Xifaxan;
- increased unit sales of MoviPrep and OsmoPrep; and
- price increases on our products.

Prescription growth for the three-month period ended June 30, 2008 compared to the corresponding three-month period in 2007 was 7% for Xifaxan and 12% for our purgatives.

Net product revenues for the six-month period ended June 30, 2008 were \$75.3 million, compared to \$126.5 million for the corresponding six-month period in 2007, a 40% decrease. The net product revenue decrease for the six-month period ended June 30, 2008 compared to the six-month period ended June 30, 2007 was primarily due to a decrease in sales of Colazal as a result of the approval of three generic balsalazide capsule products on December 28, 2007, and an increase in the return reserve for Visicol as a result of an unexpected large return from a small wholesaler, partially offset by:

- increased unit sales of Xifaxan;
- increased unit sales of MoviPrep and OsmoPrep; and
- price increases on our products.

Prescription growth for the six-month period ended June 30, 2008 compared to the corresponding six-month period in 2007 was 7% for Xifaxan and 18% for our purgatives.

On December 28, 2007, the Office of Generic Drugs approved three generic balsalazide capsule products. As a result of these generic approvals, the Company expects the future sales of Colazal to be significantly less than historical sales of Colazal. In the fourth quarter of 2007, the Company recorded a \$34.6 million reserve as a reduction of net product revenues. The balance of this reserve at June 30, 2008 was \$28.1 million. This reserve represents an estimate of the Company's liability for Colazal that may be returned by the original purchaser in accordance with the Company's stated return policy as a result of these generic approvals. This estimate was developed based on the following estimates:

- our estimate of the quantity and expiration dates of Colazal inventory in the distribution channel based on historical net product shipments less estimated historical prescriptions written;
- our estimate of future demand for Colazal based on the actual erosion of product demand for several comparable products that were previously genericized, and the most recent demand for Colazal prior to the generic approvals;
- the actual demand for Colazal experienced during 2008 subsequent to the generic approvals;
- our estimate of potential cannibalization of Colazal demand by our 1100mg balsalazide tablet if approved by the FDA;
- our estimate of chargeback and rebate activity based on price erosion as a result of the generic approvals;
- our estimate of the generic market that will be obtained by Watson, our authorized generic partner; and
- other relevant factors.

Due to the subjectivity of this estimate, the Company prepares various sensitivity analyses to ensure the Company's final estimate is within a reasonable range. A change in assumptions that resulted in a 10% change in the quantity of Colazal inventory in the distribution channel would have resulted in a change in the Colazal return reserve of approximately \$8.2 million and a corresponding change in 2007 net product revenue of approximately 3.5%. A change in assumptions that resulted in a 10% change in the estimated future demand of Colazal would have resulted in a change in the Colazal return reserve of approximately \$2.6 million and a corresponding change in 2007 net product revenue of approximately 1.1%.

Revenues from collaborative agreements for the three-month period and six-month period ended June 30, 2007 consists of an upfront payment of \$1.5 million to us upon execution of an agreement to license exclusive rights to market DIACOL™ in 28 territories in Europe to Dr. Falk Pharma GmbH of Freiberg, Germany; and a \$1.0 million milestone payment from Zeria Pharmaceutical Co., Ltd. of Tokyo, Japan as a result of their receipt of marketing approval of Visiclear® Tablets for colon cleansing in Japan. We did not receive any revenues from collaborative agreements during the three-month period or six-month period ended June 30, 2008.

Costs and Expenses

Costs and expenses for the three-month period ended June 30, 2008 were \$47.8 million, compared to \$57.3 million for the corresponding three-month period in 2007. Lower operating expenses in absolute terms for the three-month period ended June 30, 2008 compared to the corresponding period in 2007 were due primarily to decreased cost of products sold related to the corresponding decrease in product revenue, and decreased research and development activities.

Cost of Products Sold

Cost of products sold for the three-month period ended June 30, 2008 was \$7.1 million, compared with \$13.0 million for the corresponding three-month period in 2007. Cost of products sold for the six-month period ended June 30, 2008 was \$14.4 million, compared with \$25.0 million for the corresponding six-month period in 2007. The decrease in cost of products sold for the three-month and six-month periods ended June 30, 2008 compared to the three-month and six-month periods ended June 30, 2007 was due primarily to decreased sales of Colazal as a result of the approval of three generic balsalazide capsule products on December 28, 2007.

Gross margin on total product revenue, excluding \$2.3 million in amortization of product rights and intangible assets for the three-month periods ended June 30, 2008 and 2007, respectively, was 82.7% for the three-month period ended June 30, 2008 and 80.4% for the three-month period ended June 30, 2007. Gross margin on total product revenue, excluding \$4.5 million and \$4.1 million in amortization of product rights and intangible assets for the six-month periods ended June 30, 2008 and 2007, respectively, was 80.9% for the six-month period ended June 30, 2008 and 80.2% for the six-month period ended June 30, 2007.

Fees and Costs Related to License Agreements

Fees and costs related to license agreements for the three-month period ended June 30, 2008 consists of \$105,000 for the Canadian rights to Visicol. In addition, fees and costs related to license agreements for the six-month period ended June 30, 2008 consists of a \$0.5 million milestone payment to Wilmington Pharmaceuticals, and a \$1.0 million up-front payment to Dr. Falk Pharma for the exclusive license to develop and commercialize Dr. Falk Pharma's budesonide products in the United States. Fees and costs related to license agreements for the three-month period and six-month period ended June 30, 2007 relates to payments made to Cedars-Sinai Medical Center under the terms of the related license agreements; and payments of \$1.1 million to Clinical Development Capital, the successor licensor of DIACOL™ and Visiclear®, for its share of the milestone revenue of \$2.5 million recognized during the three-month and six-month periods ended June 30, 2007.

Amortization of Product Rights and Intangible Assets

Amortization of product rights and intangible assets consists of amortization of the costs of license agreements, product rights and other identifiable intangible assets, which result from product and business acquisitions. The increase for the six-month period ended June 30, 2008 compared to the corresponding period in 2007 is primarily a result of the acquisition of Pepcid in February 2007.

Research and Development

Research and development expenses were \$15.4 million for the three-month period ended June 30, 2008, compared to \$19.0 for the comparable period in 2007. Research and development expenses were \$41.3 million for the six-month period ended June 30, 2008, compared to \$40.8 million for the comparable period in 2007. The decrease in research and development expenses for the three-month period ended June 30, 2008 compared to the corresponding period in 2007 is due to the substantial completion of our 1100mg balsalazide tablet and granulated mesalamine programs during the first quarter of 2008, resulting in decreased spending on these programs in the three-month period ended June 30, 2008 compared to the three-month period ended June 30, 2007. The slight increase for the six-month period ended June 30, 2008 compared to the corresponding period in 2007 was due primarily to costs incurred related to the substantial completion of our 1100mg balsalazide tablet and granulated mesalamine programs during the first quarter of 2008, and the costs associated with ongoing late-stage studies to expand the Xifaxan label, partially offset by decreased spending in the second quarter of 2008 on our 1100mg balsalazide tablet and granulated mesalamine programs. Since inception, we have incurred research and development expenditures of approximately \$65.9 million for balsalazide, \$78.4 million for rifaximin and \$34.8 million for granulated mesalamine.

Due to the risks and uncertainties of the drug development and regulatory approval process, research and development expenditures are difficult to forecast and subject to unexpected increases. Effective January 1, 2008 we adopted EITF No. 07-3, "Accounting for Nonrefundable Advance Payments for Goods or Services Received for Use in Future Research and Development Activities". EITF 07-3 states that nonrefundable advance payments for goods or services that will be used or rendered for future research and development activities should be deferred and capitalized. Such amounts should be recognized as an expense as the related goods are delivered or the related services are performed. Adoption of EITF No. 07-3 did not have a material effect on our consolidated financial position, results of operations or cash flows. Although research and development costs should be lower in the remaining six months of 2008 compared to the first six months of 2008, generally we expect research and development costs to increase in absolute terms as we pursue additional indications and formulations for balsalazide and rifaximin, initiate development for the budesonide product candidates we recently acquired from Dr. Falk, continue to develop granulated mesalamine, and if and when we acquire new products.

Selling, General and Administrative

Selling, general and administrative expenses were \$23.0 million for the three-month period ended June 30, 2008, compared to \$21.8 million in the corresponding three-month period in 2007. Selling, general and administrative expenses were \$44.1 million for the six-month period ended June 30, 2008, compared to \$43.2 million in the corresponding six-month period in 2007. These slight increases were primarily due to an increase in marketing expenses for our purgative products and pre-marketing expenses for our balsalazide disodium tablets, partially offset by a reduction in marketing expenses for Colazal in 2008 compared to 2007.

Interest and Other Income, Net

Interest and other income, net was \$0.2 million for the three-month period ended June 30, 2008, compared to \$0.3 million in the corresponding three-month period in 2007. Interest and other income, net for the three-month period ended June 30, 2008 consisted of \$0.4 million of interest income offset by \$0.2 million of interest expense on our credit facility. Interest and other income, net for the three-month period ended June 30, 2007 consisted of \$0.7 million of interest income, offset by \$0.4 million of interest expense on our credit facility. The decrease in interest income for the three-month period ended June 30, 2008 compared to the three-month period ended June 30, 2007 is due primarily to lower interest rates on our investments in 2008, partially offset by higher cash and cash equivalent balances during 2008 as compared to 2007.

Interest and other income, net was \$0.6 million for the six-month period ended June 30, 2008 compared to \$1.2 million in the corresponding six-month period in 2007. Interest and other income, net for the six-month period ended June 30, 2008 consisted of \$1.3 million of interest income offset by \$0.7 million of interest expense on our credit facility. Interest and other income, net for the six-month period ended June 30, 2007 consisted of \$1.8 million of interest income, offset by \$0.6 million of interest expense on our credit facility. The decrease in interest income for the six-month period ended June 30, 2008 compared to the six-month period ended June 30, 2007 is due primarily to lower interest rates on our investments in 2008, partially offset by higher cash and cash equivalent balances during 2008 as compared to 2007. The increase in interest expense on our credit facility for the six-month period ended June 30, 2008 compared to the six-month period ended June 30, 2007 is primarily due to the fact that we did not enter into the credit facility until February 2007.

As a result of the execution of the amendment to our credit facility in August 2008, we will take a \$1.1 million noncash charge to expense a portion of the unamortized costs related to the credit facility under EITF No. 98-14, "Debtor's Accounting for Changes in Line-of-Credit or Revolving-Debt Arrangements".

Provision for Income Tax

Income tax expense was \$0.5 million for the three-month period ended June 30, 2008, compared to \$1.9 million in the corresponding three-month period in 2007. Income tax expense was \$1.1 million for the six-month period ended June 30, 2008, compared to \$2.5 million in the corresponding six-month period in 2007. Our effective tax rate was (7.5)% and (3.7)% for the three-month and six-month periods ended June 30, 2008, and 15.6% and 15.9% for the three-month and six-month periods ended June 30, 2007. The change in effective rate is primarily due to the increased utilization of acquisition-related deferred tax assets in the three-month and six-month periods ended June 30, 2008 as compared to the three-month and six-month periods ended June 30, 2007.

Net Income (Loss)

Net loss was \$7.1 million for the three-month period ended June 30, 2008, compared to net income of \$10.2 million in the corresponding three-month period in 2007. Net loss was \$31.1 million for the six-month period ended June 30, 2008, compared to net income of \$13.1 million in the corresponding six-month period in 2007.

Liquidity and Capital Resources

From inception until first achieving profitability in the third quarter of 2004, we financed product development, operations and capital expenditures primarily from public and private sales of equity securities and from funding arrangements with collaborative partners. Since launching Colazal in January 2001, net product revenue has been a growing source of cash. As of June 30, 2008, we had \$90.9 million in cash and cash equivalents, compared to \$111.3 million as of December 31, 2007.

Net cash used by operating activities of \$19.2 million for the six-month period ended June 30, 2008 was primarily attributable to our net loss for the period, and product returns and chargebacks for Colazal, partially offset by collection of accounts receivable for product revenue recognized in the fourth quarter of 2007. Net cash provided by operating activities for the six-month period ended June 30, 2007 of \$10.2 million was also primarily attributable to our net income for the period.

Net cash used in investing activities for the six-month period ended June 30, 2008 of \$0.7 million was primarily for the purchases of property and equipment. Net cash used in investing activities for the six-month period ended June 30, 2007 of \$56.6 million was primarily related to the acquisition of Pepcid in February 2007.

Net cash used by financing activities for the six-month period ended June 30, 2008 was \$0.5 million consisting primarily of principal payments on capital lease obligations. Net cash provided by financing activities for the six-month period ended June 30, 2007 of \$16.3 million was primarily a result of borrowings under our credit facility entered into in February 2007, which helped fund our acquisition of Pepcid OS.

As of June 30, 2008, we had non-cancelable purchase order commitments for inventory purchases of approximately \$18.6 million. We anticipate significant expenditures related to our on-going sales, marketing, product launch and development efforts associated with 1100mg balsalazide tablets, Xifaxan, Visicol, Azasan, Anusol-HC, Proctocort, OsmoPrep, MoviPrep, Pepcid Oral Suspension and granulated mesalamine. To the extent we acquire rights to additional products or product candidates, we will incur additional expenditures.

Our contractual commitments for non-cancelable purchase commitments of inventory, minimum lease obligations for all non-cancelable operating leases, and minimum capital lease obligations (including interest) as of June 30, 2008 are as follows (in thousands):

	<u>Total</u>	<u>< 1 year</u>	<u>1-3 years</u>	<u>3-5 years</u>	<u>> 5 years</u>
Operating leases	11,997	1,042	4,278	3,225	3,452
Purchase commitments	18,639	18,639	—	—	—
Capital lease obligations	1,682	545	1,137	—	—
Total	<u>32,318</u>	<u>20,226</u>	<u>5,415</u>	<u>3,225</u>	<u>3,452</u>

In February 2007, we entered into a \$100.0 million revolving credit facility that matures in February 2012. At June 30, 2008, \$15.0 million was outstanding under the credit facility. Virtually all of our assets and those of our subsidiaries secure our obligations under the credit facility. The credit facility may be used for working capital, capital expenditures, acquisitions and other general corporate purposes.

The credit facility bears interest at a rate per annum equal to, at our option, either (a) a base rate equal to the higher of (i) the Federal Funds Rate plus 1/2 of 1% and (ii) the Bank of America prime rate, or (b) a Eurodollar rate (based on LIBOR), plus, in each case, a percentage rate that fluctuates, based on the ratio of our funded debt to EBITDA (income before income taxes plus interest expense and depreciation and amortization), from 0.00% to 0.75% for base rate borrowings and 1.00% to 1.75% for Eurodollar rate borrowings. The rate as of June 30, 2008 on our outstanding borrowings was 4.33%.

The credit facility contains various representations, warranties and affirmative, negative and financial covenants customary for financings of this type. The financial covenants include a leverage test and a fixed charge test. The Company was not in compliance with these covenants at June 30, 2008.

In August 2008 the credit facility was amended to waive defaults that may have arisen as a result of the approval of three generic balsalazide capsule products by the Office of Generic Drugs on December 28, 2007 and the credit facility was reduced to \$20 million. The leverage test and fixed charge test were suspended for future periods and the margins added to the interest rate were set at 0.00% for the base rate and 1.00% for the Euro dollar rate, as long as the Company maintains an amount equal to the amount outstanding under the credit facility on deposit with the Administrative Agent of the credit facility and maintains a minimum of \$23 million in cash on its balance sheet.

As of June 30, 2008, we had an accumulated deficit of \$135.8 million and cash and cash equivalent balances of \$90.9 million. We expect to be unprofitable and experience negative cash flow during 2008, due to the approval of three generic balsalazide capsule products on December 28, 2007. We believe our cash and cash equivalent balances should be sufficient to satisfy our cash requirements for the foreseeable future. Based on our current projections, we believe that we will be able to return to a positive cash flow position without requiring additional capital. However, we might seek additional debt or equity financing or both to fund our operations or acquisitions, and our actual cash needs might vary materially from those now planned because of a number of factors, including FDA and foreign regulatory processes, the status of competitive products, including potential generics, intellectual property risks, the actual amount of Colazal returns we receive compared to our current estimates, our ability to maintain our current credit facility, our success selling products, the results of research and development activities, establishment of and change in collaborative relationships, technological advances by us and other pharmaceutical companies, and whether we acquire rights to additional products. If we incur more debt, we might be restricted in our ability to raise additional capital and might be subject to financial and restrictive covenants. If we issue additional equity, our stockholders could suffer dilution. We might also enter into additional collaborative arrangements that could provide us with additional funding in the form of equity, debt, licensing, milestone and/or royalty payments. We might not be able to enter into such arrangements or raise any additional funds on terms favorable to us or at all.

Cautionary Statement

We operate in a highly competitive environment that involves a number of risks, some of which are beyond our control. The following statement highlights some of these risks. For more detail, see “Part I. Item 1A. Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2007.

Statements contained in this Form 10-Q that are not historical facts are or might constitute forward-looking statements under the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Although we believe the expectations reflected in such forward-looking statements are based on reasonable assumptions, our expectations might not be attained. Forward-looking statements involve known and unknown risks that could cause actual results to differ materially from expected results. Factors that could cause actual results to differ materially from our expectations expressed in the report include, among others: our need to return to profitability; the possible impairment of, or inability to obtain, intellectual property rights and the costs of obtaining such rights from third parties; results of future litigation; intense competition, including potential generics; the high cost and uncertainty of the research, clinical trials and other development activities involving pharmaceutical products; the unpredictability of the duration and results of regulatory review of New Drug Applications and Investigational New Drug Applications; our dependence on a limited number of products, particularly Xifaxan, and the uncertainty of market acceptance of our products; the uncertainty of obtaining, and our dependence on, third parties to manufacture and sell our products; and other risk factors detailed from time to time in our other SEC filings.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Our purchases of raw materials are denominated in Euros. Translation into our reporting currency, the U.S. dollar, has not historically had a material impact on our financial position. Additionally, our net assets denominated in currencies other than the U.S. dollar have not historically exposed us to material risk associated with fluctuations in currency rates. Given these facts, we have not considered it necessary to use foreign currency contracts or other derivative instruments to manage changes in currency rates. However, these circumstances could change.

Item 4. Controls and Procedures

Disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)) are designed only to provide reasonable assurance that information to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and accumulated and communicated to the issuer's management, including its principal financial officer, or persons performing similar functions, as appropriate to allow timely decision regarding required disclosure. As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our management, including our President and Chief Executive Officer and Senior VP, Finance and Administration and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, our President and Chief Executive Officer and Senior VP, Finance and Administration and Chief Financial Officer have concluded that our disclosure controls and procedures are effective to provide the reasonable assurance discussed above.

There was no change in our internal control over financial reporting in the quarter ended June 30, 2008 that materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

On May 14, 2008, Salix Pharmaceuticals, Inc., Norgine, B.V. and Norgine Europe, B. V. filed a lawsuit in the United States District Court for the District of New Jersey against Novel Laboratories, Inc. for infringement of Norgine's patent protecting MoviPrep. Norgine licensed MoviPrep to Salix for commercialization in the United States. The lawsuit is in response to an Abbreviated New Drug Application, or ANDA, filed by Novel with the FDA regarding Novel's intent to market a generic version of MoviPrep in the United States prior to the September 1, 2024 expiration of U.S. patent #7,169,381, and seeks a declaratory judgment upholding the validity of the patent. Novel filed an Answer and Counterclaim on June 20, 2008.

Item 4. Submission of Matters to a Vote of Security Holders

Our 2008 Annual Meeting of Shareholders was held on June 12, 2007. The following is a brief description of each matter voted upon at the meeting and a statement of the number of votes cast for, against or withheld and the number of abstentions with respect to each matter.

- (a) The shareholders elected the following directors to serve for the ensuing year and until their successors are elected:

	FOR	WITHHELD
John F. Chappell	38,722,007	1,292,967
Thomas W. D'Alonzo	34,382,791	5,632,183
Richard A. Franco, R.Ph.	39,464,466	550,508
William Harrall III	34,505,436	5,509,538
William P. Keane	39,478,196	536,778
Carolyn J. Logan	39,587,030	427,944
Mark A. Sirgo	39,588,431	426,543

- (b) The shareholders approved the amendment of our 2005 Stock Plan to increase the number of shares of common stock reserved for issuance thereunder from 3,062,689 to 3,900,000:

FOR	AGAINST	ABSTAIN	BROKER NON VOTES
30,242,220	3,024,545	19,039	6,729,170

- (c) The shareholders ratified the appointment of PricewaterhouseCoopers LLP as our independent auditors for the fiscal year ending December 31, 2008.

FOR	AGAINST	ABSTAIN
39,866,598	80,937	67,439

Item 6. Exhibits

<u>Exhibit Number</u>	<u>Description of Document</u>	<u>Registrant's Form</u>	<u>Dated</u>	<u>Exhibit Number</u>	<u>Filed Herewith</u>
10.63	Waiver and First Amendment to Credit Agreement, by and among Salix Pharmaceuticals, Ltd., Bank of America, N.A., as Administrative Agent, and the lender parties thereto, dated as of August 4, 2008				X
31.1	Certification by the Chief Executive Officer pursuant to Section 240.13a-14 or Section 240.15d-14 of the Securities and Exchange Act of 1934, as amended.				X
31.2	Certification by the Chief Financial Officer pursuant to Section 240.13a-14 or Section 240.15d-14 of the Securities and Exchange Act of 1934, as amended.				X
32.1	Certification by the Chief Executive Officer pursuant to 18 U.S.C. 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.				X
32.2	Certification by the Chief Financial Officer pursuant to 18 U.S.C. 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.				X

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.

SALIX PHARMACEUTICALS, LTD.

Date: August 4, 2008

By: /s/ Carolyn J. Logan
Carolyn J. Logan
President and Chief Executive Officer

Date: August 4, 2008

By: /s/ Adam C. Derbyshire
Adam C. Derbyshire
Senior Vice President, Finance & Administration and
Chief Financial Officer

WAIVER AND FIRST AMENDMENT TO CREDIT AGREEMENT

THIS WAIVER AND FIRST AMENDMENT TO CREDIT AGREEMENT (as the same may from time to time be amended, restated or otherwise modified, this "Agreement") is made as of August 4, 2008 and entered into by and among SALIX PHARMACEUTICALS, LTD. (the "Borrower"), BANK OF AMERICA, N.A., as Administrative Agent (in such capacity, the "Administrative Agent"), and the lenders party hereto (collectively, the "Lenders").

RECITALS

A. The Borrower, the Lenders and the Administrative Agent have entered into that certain Credit Agreement dated as of February 22, 2007 (as amended hereby and as further amended, restated, supplemented or otherwise modified, the "Credit Agreement"), pursuant to which the Lenders have agreed to make the Loans (such term, together with each other capitalized term used in this Agreement but not defined in this Agreement, shall be defined in accordance with the Credit Agreement) and other extensions of credit, all upon the terms and conditions set forth in the Credit Agreement.

B. The Borrower has requested that the Administrative Agent and the Lenders agree to a waiver and certain amendments to the Credit Agreement.

C. Subject to the terms and conditions hereof, the Lenders are willing to grant the Borrower's requests.

D. In consideration of the agreements hereinafter set forth, and for other good and valuable consideration, the receipt and adequacy of which are hereby acknowledged, the parties hereto agree as follows:

AGREEMENT

1. Waiver. Subject to the terms and conditions hereof, including, without limitation, the conditions to effectiveness set forth in Section 3, the Administrative Agent and the Lenders hereby waive any Event of Default that may have arisen under Section 8.01(d) and/or Section 8.01(n) solely as a result of the approval by Office of Generic Drugs on December 28, 2007 of three generic balsalazide capsule products, as disclosed in the "Notes to Condensed Consolidated Financial Statements" in the Form 10-Q filed by the Borrower with the United States Securities and Exchange Commission on May 7, 2008 (the pertinent portion of which is set forth on Exhibit A hereto).

2. Amendments to the Credit Agreement. The Administrative Agent, the Lenders and the Borrower agree to amend, effective in accordance with Section 3 below, the Credit Agreement as follows:

(a) Section 1.01 of the Credit Agreement is hereby amended by amending and restating or adding (as applicable) the following definitions in their entirety:

“Applicable Rate” means, from the effective date of the Waiver and First Amendment, for so long as all Outstanding Amounts are fully cash collateralized in accordance with Section 2.14, and provided that no Default or Event of Default has occurred and is continuing, the following percentages per annum set forth for Level I. Otherwise, ‘Applicable

Rate' means the following percentages per annum, based upon the Consolidated Leverage Ratio as set forth in the most recent Compliance Certificate received by the Administrative Agent pursuant to Section 6.02(a):

<u>Level</u>	<u>Consolidated Leverage Ratio</u>	<u>Commitment Fee (bps)</u>	<u>Applicable Rate for Eurodollar Rate Loans (bps)</u>	<u>Letter of Credit Fee (bps)</u>	<u>Applicable Rate for Base Rate Loans (bps)</u>
I	Less than 1.00 to 1.00	25.0	100.0	100.0	0.0
II	Greater than or equal to 1.00 to 1.00 but less than 1.50 to 1.00	30.0	125.0	125.0	25.0
III	Greater than or equal to 1.50 to 1.00 but less than 2.00 to 1.00	35.0	150.0	150.0	50.0
IV	Greater than or equal to 2.00 to 1.00	50.0	175.0	175.0	75.0

Any increase or decrease in the Applicable Rate resulting from a change in the Consolidated Leverage Ratio shall become effective as of the first Business Day immediately following the date a Compliance Certificate is delivered pursuant to Section 6.02(a); provided, however, that if a Compliance Certificate is not delivered when due in accordance with such Section, then Pricing Level IV shall apply as of the first Business Day after the date on which such Compliance Certificate was required to have been delivered. The Applicable Rate in effect from the Closing Date until receipt by the Administrative Agent of the Borrower's Compliance Certificate for the fiscal quarter ended June 30, 2007 shall be determined based upon Pricing Level I.

Notwithstanding anything to the contrary contained in this definition, the determination of the Applicable Rate for any period shall be subject to the provisions of Section 2.10(b)."

"Waiver and First Amendment' means that certain Waiver and First Amendment to Credit Agreement dated as of August 4, 2008 by and among the Borrower, the Administrative Agent and the lenders party thereto."

(b) Article II is hereby amended by adding the following Section 2.14:

"2.14 Collateralization. Notwithstanding anything contained herein, or in any other Loan Document, to the contrary, the Borrower shall pledge and deposit with the Administrative Agent, for the benefit of the Secured Parties, an amount in cash equal to 100% of all Outstanding Amounts as cash collateral for the Obligations and pursuant to documentation in form and substance reasonably satisfactory to the Administrative Agent (which documents are hereby consented to by the Lenders). Such cash collateral shall be maintained in a blocked deposit account or certificate of deposit at Bank of America and shall be subject to the dominion

and control of the Administrative Agent. The Borrower hereby reaffirms the security interests granted under the Collateral Agreement, which such grants include a security interest in all cash, deposit accounts, certificates of deposit and all balances therein and all proceeds of the foregoing, including, without limitation, the cash collateral and related account contemplated hereby, all in favor of the Administrative Agent and for the benefit of the Secured Parties. In addition to the other conditions and requirements for Credit Extensions set forth herein, no further Credit Extension shall be permitted unless and until each such requested Credit Extension is fully cash collateralized in accordance herewith.”

(c) Section 4.02 of the Credit Agreement is hereby amended by adding the following item (d):

“(d) The Administrative Agent shall have received cash collateral in an amount equal to 100% of each such Credit Extension in accordance with Section 2.14.”

(d) Section 6.02(a) of the Credit Agreement is hereby amended and restated as follows:

“(a) subject to the limitation set forth in Section 7.12(d), concurrently with the delivery of the financial statements referred to in Sections 6.01(a) and (b), a duly completed Compliance Certificate signed by the chief executive officer, chief financial officer, treasurer or controller of the Borrower;”

(e) Section 7.12 is hereby amended and restated in its entirety to read as follows:

“7.12 Financial Covenants.

(a) Consolidated Leverage Ratio. Except as provided in subsection (d) below, permit the Consolidated Leverage Ratio at any time during any period of four fiscal quarters of the Borrower to be greater than 2.75 to 1.00;

(b) Consolidated Fixed Charge Coverage Ratio. Except as provided in subsection (d) below, permit the Consolidated Fixed Charge Coverage Ratio as of the end of any fiscal quarter of the Borrower to be less than 1.25 to 1.00;

(c) Minimum Cash Balance. At all times maintain a cash balance on the balance sheet of the Borrower of not less than \$23,000,000.

(d) From the effective date of the Waiver and First Amendment, so long as all Outstanding Amounts are fully cash collateralized in accordance with Section 2.14, and provided that no Default or Event of Default has occurred and is continuing, compliance by the Borrower and its Subsidiaries with the financial covenants set forth in subsection (a) and subsection (b) above shall be suspended. In furtherance thereof, during such period neither the Borrower nor any of its Subsidiaries shall be required to complete a Compliance Certificate pursuant to Section 6.02(a) with respect to Sections 7.12(a) and 7.12(b); provided that nothing in this subsection (d) shall be deemed to limit or otherwise restrict the scope or type of information that the Administrative Agent and Lenders may request from the Borrower and its Subsidiaries under this Agreement, including, without limitation, Compliance Certificates showing financial covenant calculations.”

(f) Schedule 2.01 of the Credit Agreement is hereby amended and restated in its entirety to read as set forth on Schedule 2.01 hereto.

(g) Exhibit D of the Credit Agreement is hereby amended and restated in its entirety to read as set forth on Exhibit D hereto.

(h) All references to “RBC Centura Bank” in the Credit Agreement and all other applicable Loan Documents are hereby amended to read “RBC Bank (USA) (formerly known as RBC Centura Bank).”

3. Effectiveness; Conditions Precedent. This Agreement shall be effective when all of the conditions set forth in this Section 3 shall have been satisfied in form and substance satisfactory to the Administrative Agent:

(a) The Administrative Agent shall have received duly executed counterparts of this Agreement from each of the Borrower, its Subsidiaries, the Administrative Agent and each Lender consenting to the terms hereof (each such Lender, a “Consenting Lender”) and acknowledged by each Lender not consenting to this Agreement and exiting the credit facility concurrently with the effectiveness hereof (each such Lender, an “Exiting Lender”).

(b) The Borrower shall have paid all reasonable professional fees and expenses of the Administrative Agent in connection with this Agreement, the Loan Documents and the transactions contemplated hereby (including all reasonable fees and expenses of Winston & Strawn LLP in its capacity as counsel to the Administrative Agent) pursuant to wire transfer instructions to be provided by the Administrative Agent.

(c) In addition to any amounts previously paid or owing to the Administrative Agent or Lenders, the Borrower shall have paid to the Administrative Agent for the benefit of each Consenting Lender a consent fee in an amount equal to 25 basis points times the sum of each Consenting Lender’s Commitment (after giving effect to the Commitment Reduction set forth in Section 2 (f) above).

(d) The Administrative Agent shall have received a favorable opinion of counsel to the Borrower, addressed to the Administrative Agent and each Lender, in form and substance satisfactory to the Administrative Agent.

(e) The deposit account (the “Cash Collateral Account”) referenced in Section 2(b) hereof shall have been established and cash collateral in an amount equal to 100% of all Outstanding Amounts shall have been deposited therein.

(f) The Cash Collateral Account shall be subject to a deposit account control agreement perfecting the Administrative Agent’s security interest (for the benefit of the Secured Parties).

(g) The Administrative Agent shall have received such other instruments, documents and certificates as the Administrative Agent shall reasonably request in connection with the execution of this Agreement.

4. Lender Consent. By their execution hereof, each Consenting Lender and each Exiting Lender consents to the non pro-rata repayment in full and exit of each Exiting Lender, notwithstanding any provision of the Credit Agreement (including without limitation, Section 2.13) or any other Loan Document.

5. **Representations and Warranties.** Each Loan Party hereby represents and warrants to the Administrative Agent and the Lenders that (a) each Loan Party has the legal power and authority to execute and deliver this Agreement; (b) the officers of each Loan Party executing this Agreement have been duly authorized to execute and deliver the same and bind each Loan Party with respect to the provisions hereof; (c) the execution and delivery hereof by each Loan Party and the performance and observance by each Loan Party of the provisions hereof do not violate or conflict with any organizational document of any Loan Party or any law applicable to any Loan Party or result in a breach of any provision of or constitute a default under any other agreement, instrument or document binding upon or enforceable against any Loan Party; (d) (after giving effect to the waiver set forth in Section 1) no Default or Event of Default exists under the Credit Agreement, nor will any occur immediately after the execution and delivery of this Agreement or by the performance or observance of any provision hereof; (e) no Loan Party is aware of any claim or offset against, or defense or counterclaim to, any Loan Party's obligations or liabilities under the Credit Agreement or any other Loan Document; (f) this Agreement and each document executed by each Loan Party in connection herewith constitute valid and binding obligations of the applicable Loan Party in every respect, enforceable in accordance with their terms; (g) no Loan Party has received a notice of default of any kind from any material account debtor or any counterparty to a Material Contract and no material account debtor or counterparty to a Material Contract has asserted any right of set-off, deduction or counterclaim with respect to any account or such Material Contract, respectively and (h) (after giving effect to the waiver set forth in Section 1) all representations and warranties made by the Borrower and contained in this Agreement, the Credit Agreement or any other Loan Document to which it is a party are true and correct in all material respects on and as of the date of this Agreement to the same extent as though made on and as of such date, except to the extent that any thereof expressly relate to an earlier date.

6. **Release.** Each Loan Party hereby waives and releases the Administrative Agent, each Lender and their respective directors, officers, employees, agents, attorneys, affiliates and subsidiaries (each a "Releasee") from any and all claims, offsets, defenses and counterclaims, known and unknown, that any Loan Party may have as of the date of this Agreement based upon, relating to, or arising out of the Obligations and related transactions in any way.

Notwithstanding the foregoing, this Section 6 shall not constitute a release of the obligations of the Administrative Agent or any Lender under the Loan Documents, such waiver and release being with full knowledge and understanding of the circumstances and effect thereof and after having consulted legal counsel with respect thereto.

7. **Covenant Not to Sue.** Each Loan Party, on behalf of itself and its successors, assigns, and other legal representatives, hereby absolutely, unconditionally and irrevocably, covenants and agrees with and in favor of each Releasee that it will not sue (at law, in equity, in any regulatory proceeding or otherwise) any Releasee on the basis of any claim released, remised and discharged by such Loan Party pursuant to Section 6 above. If any Loan Party or any of its successors, assigns or other legal representations violates the foregoing covenant, such Loan Party, for itself and its successors, assigns and legal representatives, agrees to pay, in addition to such other damages as any Releasee may sustain as a result of such violation, all attorneys' fees and costs incurred by any Releasee as a result of such violation.

8. **Loan Documents Unaffected.** Except as otherwise specifically amended hereby, all provisions of the Credit Agreement and the other Loan Documents shall remain in full force and effect and be unaffected hereby. The parties hereto acknowledge and agree that this Agreement constitutes a "Loan Document" under the terms of the Credit Agreement.

9. Subsidiary Guarantor Acknowledgement. Each Subsidiary Guarantor, by signing this Agreement:

(a) Consents and agrees to and acknowledges the terms of this Agreement, including, without limitation, the waiver and amendments to the Credit Agreement set forth herein.

(b) Acknowledges and agrees that all of the Loan Documents to which such Subsidiary Guarantor is a party or otherwise bound shall continue in full force and effect and that all of such Subsidiary Guarantor's obligations thereunder shall be valid and enforceable and shall not be impaired or limited by the execution or effectiveness of this Agreement.

(c) Represents and warrants to the Administrative Agent and the Lenders that all representations and warranties made by such Subsidiary Guarantor and contained in this Agreement or any other Loan Document to which it is a party are true and correct in all material respects on and as of the date of this Agreement to the same extent as though made on and as of such date, except to the extent that any thereof expressly relate to an earlier date.

(d) Acknowledges and agrees that (i) notwithstanding the conditions to effectiveness set forth in this Agreement, such Subsidiary Guarantor is not required by the terms of the Credit Agreement or any other Loan Document to which such Subsidiary Guarantor is a party to consent to the terms of this Agreement and (ii) nothing in the Credit Agreement, this Agreement or any other Loan Document shall be deemed to require the consent of such Subsidiary Guarantor to any future waivers or amendments or modifications to the Credit Agreement.

10. No Other Promises or Inducements. There are no promises or inducements that have been made to any party hereto to cause such party to enter into this Agreement other than those that are set forth in this Agreement. This Agreement has been entered into by the Borrower and each Subsidiary Guarantor freely, voluntarily, with full knowledge, and without duress, and, in executing this Agreement, neither the Borrower nor any Subsidiary Guarantor is relying on any other representations, either written or oral, express or implied, made to the Borrower or any Subsidiary Guarantor by the Administrative Agent. The Borrower and each Subsidiary Guarantor agrees that the consideration received by the Borrower under this Agreement has been actual and adequate.

11. No Course of Dealing. Each Loan Party acknowledges and agrees that, (a) this Agreement is not intended to, nor shall it, establish any course of dealing between the Loan Parties, the Administrative Agent and the Lenders that is inconsistent with the express terms of the Credit Agreement or any other Loan Document, (b) notwithstanding any course of dealing between the Loan Parties, the Administrative Agent and the Lenders prior to the date hereof, except as set forth herein, the Lenders shall not be obligated to make any Loan, except in accordance with the terms and conditions of this Agreement and the Credit Agreement (as amended hereby), and (c) neither the Administrative Agent nor any Lender shall be under any obligation to forbear from exercising any of its rights or remedies upon the occurrence of any Default or Event of Default. Nothing herein modifies the agreements among the Administrative Agent and the Lenders with respect to the exercise of their respective rights and remedies under the terms of the Credit Agreement.

12. No Waiver. Each Loan Party acknowledges and agrees that other than as expressly set forth in Section 1 (a) this Agreement shall not operate as a waiver of any right, power or remedy of the Administrative Agent or the Lenders under the Credit Agreement or any Loan Document, nor shall it constitute a continuing waiver at any time and (b) nothing herein shall be deemed to constitute a waiver of any Default or Event of Default and, nothing herein shall in any way prejudice the rights and remedies of

the Administrative Agent or the Lenders under the Credit Agreement, any Loan Document or applicable law. In addition, the Administrative Agent shall have the right to waive any condition or conditions set forth in this Agreement, the Credit Agreement or any Loan Document, in its sole discretion, and any such waiver shall not prejudice, waive or reduce any other right or remedy that the Administrative Agent may have against any Loan Party.

13. Governing Law. THIS AGREEMENT SHALL BE GOVERNED BY, AND CONSTRUED IN ACCORDANCE WITH, THE LAWS OF THE STATE OF NEW YORK.

14. Entire Agreement. This Agreement sets forth the entire agreement and understanding among the parties as to the subject matter hereof and merges and supersedes all prior discussions, agreements, and undertakings of every kind and nature among them with respect to the subject matter hereof.

15. Counterparts. This Agreement may be executed in any number of counterparts, and by the parties hereto on the same or separate counterparts and by facsimile signature, and each such counterpart, when executed and delivered, shall be deemed to be an original, but all such counterparts shall together constitute but one and the same Agreement.

16. Successors and Assigns. The provisions of this Agreement shall be binding upon and inure to the benefit of the parties hereto and their respective successors and assigned in accordance with Section 10.06 of the Credit Agreement.

17. Severability Of Provisions; Captions; Attachments. Wherever possible each provision of this Agreement shall be interpreted in such manner as to be effective and valid under applicable law. Any provision of this Agreement that is prohibited or unenforceable in any jurisdiction shall, as to such jurisdiction, be ineffective to the extent of such prohibition or unenforceability without invalidating the remaining provisions hereof or affecting the validity or enforceability of such provision in any other jurisdiction. The captions to Sections and subsections herein are inserted for convenience only and shall be ignored in interpreting the provisions of this Agreement. Each schedule or exhibit attached to this Agreement shall be incorporated herein and shall be deemed to be a part hereof.

18. JURY TRIAL WAIVER. EACH OF THE UNDERSIGNED, TO THE EXTENT PERMITTED BY LAW, HEREBY WAIVE ANY RIGHT TO HAVE A JURY PARTICIPATE IN RESOLVING ANY DISPUTE WHETHER SOUNDING IN CONTRACT, TORT, OR OTHERWISE, AMONG THEM, OR ANY OF THEM, ARISING OUT OF, IN CONNECTION WITH, RELATED TO OR INCIDENTAL TO THE RELATIONSHIP ESTABLISHED AMONG THEM IN CONNECTION WITH THIS AGREEMENT OR ANY DOCUMENT EXECUTED OR DELIVERED IN CONNECTION HEREWITH OR THE TRANSACTIONS RELATED THERETO.

Borrower

IN WITNESS WHEREOF, the undersigned has caused this Agreement to be duly executed as of the date first above written.

SALIX PHARMACEUTICALS, LTD.

By: /s/ Adam C. Derbyshire

Name: Adam C. Derbyshire

Title: Senior Vice President and
Chief Financial Officer

Subsidiary Guarantor Acknowledgement and Consent

IN WITNESS WHEREOF, the undersigned hereby acknowledges and consents to this Agreement as of the date first above written.

SALIX PHARMACEUTICALS, INC.

By: /s/ Adam C. Derbyshire

Name: Adam C. Derbyshire

Title: Senior Vice President and
Chief Financial Officer

Subsidiary Guarantor Acknowledgement and Consent

IN WITNESS WHEREOF, the undersigned hereby acknowledges and consents to this Agreement as of the date first above written.

GLYCYX PHARMACEUTICALS, LTD.

By: /s/ Adam C. Derbyshire

Name: Adam C. Derbyshire

Title: Senior Vice President and
Chief Financial Officer

Subsidiary Guarantor Acknowledgement and Consent

IN WITNESS WHEREOF, the undersigned hereby acknowledges and consents to this Agreement as of the date first above written.

INKINE PHARMACEUTICAL COMPANY, INC.

By: /s/ Adam C. Derbyshire

Name: Adam C. Derbyshire

Title: Senior Vice President and
Chief Financial Officer

Subsidiary Guarantor Acknowledgement and Consent

IN WITNESS WHEREOF, the undersigned hereby acknowledges and consents to this Agreement as of the date first above written.

CORBEC PHARMACEUTICALS, INC.

By: /s/ Adam C. Derbyshire

Name: Adam C. Derbyshire

Title: Senior Vice President and
Chief Financial Officer

Subsidiary Guarantor Acknowledgement and Consent

IN WITNESS WHEREOF, the undersigned hereby acknowledges and consents to this Agreement as of the date first above written.

SANGEN PHARMACEUTICAL COMPANY

By: /s/ Adam C. Derbyshire

Name: Adam C. Derbyshire

Title: Senior Vice President and
Chief Financial Officer

Administrative Agent

IN WITNESS WHEREOF, the undersigned has caused this Agreement to be duly executed as of the date first above written.

BANK OF AMERICA, N.A., as Administrative Agent

By: /s/ Anne Zesche

Name: Anne Zesche

Title: Vice President

Consenting Lender

IN WITNESS WHEREOF, the undersigned has caused this Agreement to be duly executed as of the date first above written.

BANK OF AMERICA, N.A.

By: /s/ Lynette Songy
Name: Lynette M. Songy
Title: Senior Vice President

Consenting Lender

IN WITNESS WHEREOF, the undersigned has caused this Agreement to be duly executed as of the date first above written.

WACHOVIA BANK, N.A.

By: /s/ C. Douglass Riddle

Name: C. Douglass Riddle

Title: Senior Vice President

Consenting Lender

IN WITNESS WHEREOF, the undersigned has caused this Agreement to be duly executed as of the date first above written.

RBC BANK (USA)
(formerly known as RBC Centura Bank)

By: /s/ Richard Brown

Name: Richard Brown

Title: Senior Vice President

Consenting Lender

IN WITNESS WHEREOF, the undersigned has caused this Agreement to be duly executed as of the date first above written.

Branch Banking and Trust Company

By: /s/ Jack M. Frost

Name: Jack M. Frost

Title: Senior Vice President

Consenting Lender

IN WITNESS WHEREOF, the undersigned has caused this Agreement to be duly executed as of the date first above written.

LASALLE BANK NATIONAL ASSOCIATION

By: /s/ Lynette Songy

Name: Lynette M. Songy

Title: Senior Vice President

Exiting Lender

IN WITNESS WHEREOF, the undersigned has caused this Agreement to be duly executed as of the date first above written.

FIRST HORIZON BANK

By: /s/ Andy Cook

Name: Andy Cook

Title: Senior Vice President

