

SUPERIOR COURT OF ARIZONA
MARICOPA COUNTY

CV 2009-028831

04/09/2015

HON. JOHN REA

CLERK OF THE COURT
L. Gilbert
Deputy

SANTOSH GEORGE KOTTAYIL, et al.

LAURA E SIXKILLER

v.

INSYS THERAPEUTICS INC, et al.

JENNIFER JOAN AXEL

JOEL P HOXIE
MATTHEW R KIPP
EDWARD P WELCH

DRAFT RULING PRIOR TO ORAL ARGUMENT

Dr. George Kottayil, individually and as Trustee, together with family members, brought this action after their shares in Insys were eliminated in a reverse stock split. They contend that the 2009 reverse stock split, as well as the 2008 debt-to-equity conversion that diluted their interest in Insys, fail the entire fairness standard. The plaintiffs seek damages under a variety of theories from both the entity that was the original Insys and the entity now known as Insys. (Throughout the litigation the parties and Court have referred to the original entity as Old Insys and the entity currently named Insys as New Insys.) In addition, Dr. Kottayil alleges that several assignments of patent rights were fraudulently induced and should be rescinded.

Old Insys contends that both the 2008 conversion and the 2009 split were entirely fair in process and price, each action being resorted to to maintain solvency in the face of deteriorating financial circumstances. Old Insys also advances counterclaims against Dr. Kottayil for breach of his fiduciary duty as an officer, fraud, and negligent misrepresentation.

After extensive motion practice, the case went to trial for 19 days, with over 1600 exhibits marked. The parties have filed proposed findings of fact and conclusions of law just

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over 500 pages. The Court is issuing this draft decision to allow the parties to prepare for final oral argument, after which the Court will make its final decision. This draft addresses the primary claims but not every issue. The Court emphasizes that this is a draft and findings and conclusions herein are preliminary and may change materially after oral argument.¹

Introduction

The crux of this case is the value of shares in a closely held, startup, pre-revenue pharmaceutical company. In 2008 and 2009, the times of valuation, the most optimistic projections predicted that the first revenue was years ahead. In between the date of value and any revenue lay hurdles like FDA approval (and in the case of Old Insys's Dronabinol product, DEA scheduling considerations) and practical manufacturing issues to produce a stable, marketable product.

Complicating the analysis in this case even more is the influence of hindsight bias. In the five years from the inception of the case to the time of trial, Insys's products reached the market, it had a successful IPO, and the company was profitable beyond any of the projections made during the events at issue.

As explained in more detail in the final decision, the Court finds that the 2008 debt conversion was entirely fair but the 2009 reverse stock split fails the entire fairness standard.

2009 reverse stock split

The 2009 reverse stock split was deficient both procedurally and in price. The share price for the minority shareholders frozen out was not the product of an independent valuation, or approved by an independent majority of Directors, or accepted by a majority of minority shareholders. The most persuasive evidence indicated that Dr. Kapoor declared his desire to remove all equity owners but himself and his affiliated entities and provided a figure that was unquestioningly accepted by management and Directors. Mr. Babich testified that he performed a DCF analysis but its details are unavailable since Mr. Babich did not have the foresight to save his work (or had the foresight not to save it).

Old Insys's argument in support of the \$.10 per share price for the reverse stock split emphasizes product setbacks, failed fundraising efforts, deteriorating market prospects, and

¹ The court wishes to express its appreciation and admiration for the extremely high quality of advocacy on all sides through the course of this litigation. The court often observes that the quality of judging is usually a direct reflection of the quality of the lawyering in a case. In this case, if the court's decision is not of the highest quality, it is only the court's fault.

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potential bankruptcy. On the other hand, the plaintiffs point out that the SL Fentanyl product was in phase 3 trials, had received very promising reports during the trials, all of which was highly publicized by Insys. There is evidence to support both views. The Court finds that the evidence of the promise of the SL Fentanyl product is the more persuasive, for several reasons.

The parties offered extensive expert testimony on value. In the great majority of valuation cases reviewed by the Court the experts begin with a history of revenue, together with historic data collected on the size and performance of the overall market and the subject's market share. From that objective data, the experts use their professional judgment to extrapolate into the future to arrive at figures for projected revenue, terminal value, discount rates, and the other factors that go into a discounted cash flow analysis.

Almost none of the objective data that provide some reliability to expert opinion on value exists in this case. The subjective aspects of the traditional methods of valuation overwhelm the very limited objective data available for a valuation. The result is a delta between the parties' experts of around one billion dollars. Mr. Dages, a very experienced valuation expert, testified he had never seen such a difference.

The aim of valuation is to estimate the value that a reasonable investor would place on the company. In this case, because the factors by which the very well qualified and experienced experts formed their opinions about this hypothetical investor are so fraught with uncertainty and subjectivity, the Court finds neither reasonably reliable. There is, however, one knowledgeable investor whose actions provide enough objective data to guide the Court in making some general judgments. That investor is Dr. Kapoor.

The dismal picture of 2009 painted by Old Insys is in sharp contrast to significant evidence. First, to refer to Old Insys as insolvent or close to bankruptcy is a non sequitur. The business plan from the first was that Dr. Kapoor would support the company until it could achieve a revenue stream from a generic Dronabinol product that would finance the company's primary goal of a branded SL Fentanyl spray product. The concept that Old Insys did not have sufficient revenue to meet expenses simply does not apply. Old Insys would continue to pay its bills as long as Dr. Kapoor believed the company had value that justified his ongoing support. There is ample evidence that he strongly held that belief.

In July of 2008, Dr. Kapoor caused affiliated trusts and family members to invest \$10 million in new money in Old Insys. In the year between the debt conversion and reverse split, Dr. Kapoor loaned another \$6 million. Within months of the reverse split, Dr. Kapoor had loaned the company another \$5 million. Since the focus here is on the 2008/2009 period, the Court will merely note at this point that Dr. Kapoor put into the company \$12.25 million in 2010 and \$15.25 million in 2011, all before any revenue was generated.

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To be sure, the company faced serious problems with its Dronabinol product. The news about the Fentanyl product, however, was almost all good. The proof of concept study was completely successful. The phase 3 safety and efficacy studies had 70% of the proposed patient population, and numerous anecdotal reports were positive and extremely encouraging. The cost and ongoing efforts to complete the phase 3 studies were minor delays, not serious obstacles. The company bragged about the SL Fentanyl product, its progress and promise, publicly, at every opportunity.

Thus, at the time of the reverse stock split, Dr. Kapoor wanted all the company, at a cheap price, and then continued to inject tens of millions of dollars. Either Dr. Kapoor suffered from a serious case of the sunk cost fallacy or his opinion of the prospects and potential of Old Insys and the value of its products was far more optimistic than that portrayed by Old Insys in this case. Given his unquestioned experience, success, and business acumen, the Court finds the latter view far more credible. To say that \$.10 a share was a fair price to buy out the plaintiffs' shares is to say that Dr. Kapoor would have been pleased and willing to sell the entire company, with all its intellectual property and its SL Fentanyl product in phase 3 trials, for \$3 million. The Court does not find the notion plausible.

The remedial phase of the case is the most difficult. Oral argument may be most helpful here. The reasonable range of fair value is a large one. The values used by JMP and Natixis in trying to launch the IPO are noticeably higher than those arrived at by E&Y and WTAS. The evidence is persuasive that the IPO was abandoned primarily because of market conditions rather than a perceived inability to convince the market of the value of the company. One possible remedy would be based on 4.83% of a fair value of \$160,000 million.

At the same time, there are factors in this case that Delaware law recognizes as justifying a monetary remedy in an entire fairness action that differs from what an appraisal would generate. There is overreaching by Dr. Kapoor. The Court does not fully accept the plaintiffs' narrative that Dr. Kapoor set out from the beginning to extract the value of Dr. Kottayil's creativity while intending to treacherously prevent him from sharing the benefits of his work, but the evidence supports a kernel of validity to the theory.

Dr. Kottayil's descent in importance and eventual ouster began in early 2007 as part of the initial positioning for an IPO and accelerated in midyear after the Major Amendment letter. The company's requests that he step down as President and from the Board are explainable in light of the planned IPO. It appears that the Major Amendment letter caused Dr. Kapoor and Mr. Babich to lose most, if not all, of their confidence in Dr. Kottayil as a science officer and bring in Dr. Archarya four months after the FDA's criticisms of Dr. Kottayil's ANDA.

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Despite Dr. Kottayil's diminishing role in the company, Dr. Kapoor maintained some sense of loyalty, refusing Mr. Babich's requests to terminate Dr. Kottayil for a year, until August 2008.

Given the facts just recited, and the prompt reacquisition of options by people who remained employees after the reverse stock split, the Court finds a strong inference that the primary purpose of the reverse stock split was the elimination of Dr. Kottayil not only as an employee but as an owner. Although "rapacious" is too strong a term, it was done in an unfair manner and at an unfair price and at a time when the success of the SL Fentanyl could clearly be perceived on the horizon. Thus, the Court is not entirely convinced at this time that 4.83% of \$160 million is "fair enough."

On the other hand, under the circumstances of this case, the Court finds that the plaintiffs' more ambitious rescissory /disgorgement of wrongful profits theory of damages based on the highest intervening value is not appropriate. Plaintiffs desire to enjoy all the benefits of equity ownership in Old Insys without sharing any of the risks. This is generally true but most pointedly brought out in their rejection of the November 2009 offer to buy all the shares they wanted at the same price as the reverse split.

Oral argument may clarify some or all of these issues.

Rescission of patent assignments

Dr. Kottayil's attempt to rescind the patent assignments is based on his version of his self-denominated Founders' Agreement. When Dr. Kapoor and Dr. Kottayil began the Insys project, they generally contemplated a 75-25% ownership. The percentages changed with the corporation's formative documents and changed further in 2005 with the Agreement with Respect to Restricted Stock. The so-called Founders' Agreement is vague, unenforceable, and insufficient to justify any reasonable reliance that Dr. Kottayil would continue to be an equity owner beyond what the corporate documents and Delaware law would provide. The statements of individual directors and Dr. Kapoor of the value of Dr. Kottayil's equity interest can only be construed as statements based on contemporaneous circumstances and not promises of the future.

At the time Dr. Kottayil signed the IP Assignment Contract he was an employee of Old Insys earning a higher wage than he had ever made in his professional career and was also an equity owner. Dr. Kottayil well knew that no pharmaceutical company could function in the marketplace or attract equity investment if it did not own its intellectual property.

Finally, the equitable remedy of rescission is inappropriate because the interests asserted by Dr. Kottayil can adequately be remedied in the damages awarded for the 2009 transaction.

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Successor liability

The plaintiffs' claims against New Insys are phrased in terms of successor liability and fraudulent transfer. In 2010, Old Insys entered into a reverse triangular merger involving NeoPharm and a wholly owned subsidiary ITNI Merger Sub. The end result was that shareholders of Old Insys became shareholders of NeoPharm and NeoPharm owned all the shares of Old Insys. NeoPharm then changed its name to Insys. New Insys is the parent and Old Insys is the subsidiary, although in the financial accounting world Old Insys was the acquirer and New Insys the acquire. The two corporations file consolidated financial statements. Old Insys is the sole operating entity.

The Court largely agrees with the defendants' proposed findings, pages 58-63.

Old Insys's counterclaims

Old Insys advanced counterclaims against Dr. Kottayil for his actions as an officer and employee connected to the hard gel Dronabinol project. Old Insys alleges that Dr. Kottayil breached his fiduciary duty and made fraudulent and negligent misrepresentations about the probable success of the product, the quality of the ANDA, the time line for approval, and the details of the problems encountered with purity and leaking, among other things. The Court finds the counterclaims, in all three manifestations, to be without merit.

The strategic decision made by Dr. Kottayil as an officer to pursue a HG, room temperature stable, product is protected by the business judgment rule. Statements about the quality of the ANDA as submitted, the prospects for success, time periods for various approvals, and other similar matters are all expressions of opinion and estimation, not fact. Dr. Kapoor, with his extensive experience in the field, could not have reasonably considered them otherwise. The same is true for the other officers and directors of Old Insys. The Court finds the evidence insufficient to prove that Dr. Kottayil either intentionally or negligently made false statement of fact that were reasonably relied upon by Old Insys.