IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE
IN AND FOR NEW CASTLE COUNTY

KERRY P. GRAY,	)	
	)	
Petitioner,	)	
	)	
v.	)	C.A. No. 17451
	)	
CYTOKINE PHARMASCIENCES, INC., a Delaware corporation,	)	
	)	
	)	
Respondent.	)	

MEMORANDUM OPINION

Submitted: November 20,2001
Decided: April 25, 2002

James F. Burnett, Esquire, POTTER ANDERSON & CORROON, Wilmington, Delaware, *Attorneys for Petitioner.*

Gregory P. Williams, Esquire, Raymond J. DiCamillo, Esquire, Kelly C. Ashby, Esquire, RICHARDS, LAYTON & FINGER, Wilmington, Delaware, *Attorneys for Respondent.*

LAMB, Vice Chancellor

I. Preliminary Statement

In this appraisal action, filed pursuant to Section 262 of the Delaware General Corporation Law ("DGCL"), the court is called upon to determine the fair value of the shares of common stock of PharmaSciences, Inc. ("PSI" or "Company"), a Delaware corporation, as of June 30, 1999, the date on which it merged ("Merger") with and into Cytokine Networks, Inc. ("CNI"). The surviving corporation then changed its name to Cytotokine PharmaSciences, Inc. ("CPSI"). Pursuant to the Merger, each share of PSI common stock was converted into the right to receive approximately 59.4 shares of CPSI common stock. Petitioner made a timely demand for appraisal in accordance with the requirements of Section 262 of the DGCL. Petitioner contends that PSI's fair equity value at the time of the Merger was $192.5 million, or $3,330 per share. Petitioner also seeks 8.3 1% interest compounded monthly on his appraisal award, plus his costs and expenses including reasonable expert witness and attorney's fees.

The Respondent contends that the fair value of PSI at the time of the Merger was $26.5 million, or $458 per share of common stock. Respondent agrees that interest should be awarded at the rate of 8.3 1% but argues that it

should be compounded quarterly not monthly. Respondent also objects to any award of expert witness or attorney's fees.

For reasons discussed below, I find that (i) the going concern value of PSI common stock, as of June 30, 1999, was $1,114 per share, or a total of $659,458 for the 592 shares subject to appraisal; (ii) the Petitioner is entitled to 8.3 1% interest compounded monthly; and (iii) the Petitioner is not entitled to an award of legal fees or expenses.

II. Background

A. PSI's Creation

PSI was incorporated in Delaware on February 25, 1992. From its inception to the date of the Merger, PSI was a closely held corporation primarily in the business of developing drug delivery products. Drug delivery is the method of delivering a biological or pharmaceutical compound into the body in an efficient manner in order to optimize the therapeutic effect and/or minimize side effects.

PSI was founded by Petitioner, Kerry Gray, along with Richard P. Storm and Dennis F. Willson. Gray was employed by PSI for eighteen months during 1992- 1993. At the time of the Merger, Gray owned 592 of the 57,800 issued and outstanding shares of PSI common stock. Immediately

prior to the Merger, Storm was President and CEO of PSI while Willson held the positions of Vice President and Secretary. Both Storm and Willson were involved in making financial projections for the Company.

PSI was not fully funded until May 28, 1993, when Acquisition and Shareholders Agreements were signed. The parties to the shareholders agreement included Montgomery Medical Ventures ("MMV"), a venture capital fund that focused on the health science area, and entities owned or controlled by Jeffrey Picower. Picower, directly or indirectly, controlled a majority of the outstanding shares of PSI common stock.

B. PSI's Operations

To evaluate the different products being developed and sold by PSI at the time of the Merger, some understanding of government regulation of pharmaceutical products is necessary.

1. Regulatory Approval

A new drug or drug delivery system must proceed through various stages of testing in order to obtain FDA approval. The initial stage consists of laboratory and animal testing and is often termed "preclinical testing. " The next stage is Phase I, which involves testing done on a small group of volunteers. The purpose of Phase I testing is to determine safety and dosage.

The product then moves to Phase II, which typically involves testing on 100 to 300 patient volunteers for the purpose of evaluating efficacy and side effects. Finally, 1,000 to 5,000 patient volunteers are used in Phase III testing to monitor adverse reactions to long-term use and to determine the effectiveness of the product.

Drug delivery companies such as PSI apply proprietary techniques to create new pharmaceutical products based on drugs developed by others. These products are generally novel, cost-effective dosage forms that provide any of several benefits, such as improved safety, efficacy and ease of use. The risks and costs inherent to commercializing a pharmaceutical product are considerably minimized when developing an alternative delivery system for a currently approved drug. While on average it takes 10 to 15 years to bring a new chemical entity to market, a new delivery formulation of an existing approved product takes on average 5 years.

2. PSI's Products

At the time of the Merger, Cervidil® was the Company's only product on the market. Cervidil® is a vaginal insert used to ripen the cervix when there is a need to induce labor. The insert, which is attached to a string for ease of removal, contains Dinoprostone ("PGE_2") in a controlled-release

hydrogel polymer. Cervidil® has a number of advantages over competitive products. In particular, it is control released, which eliminates dosing, and it can be easily removed in case of an adverse reaction. Through the Company's sole licensee in the United States, Forest Laboratories, Cervidil® has captured over 85 % of the relevant United States market.

Outside the United States, Cervidil® is marketed under the name Propess®. Prior to the Merger, Propess® had been launched in the U.K., Canada and Sweden. It was scheduled to launch in France in 1999; in Germany, Norway and Switzerland in late 1999 or 2000; in Australia and New Zealand in late 1999 or early 2000; and in Japan beginning in 2002.

At the time of the Merger, PSI had three products in its development pipeline: an erectile dysfunction product ("ED Product"), a Parkinson's disease product and a mucositis product. Both the Parkinson's disease product and the mucbsitis product were in Phase I of development. Both products used the same hydrogel polymer that was used in Cervidil® but these products were designed for oral delivery.

The ED Product was developed by Dr. Gary Neal, founder and CEO of AndroSolutions, Inc. Dr. Neal first approached PSI in late 1996 to obtain a small quantity of PGE_2 for work he was doing in the area of erectile

dysfunction. In exchange for the PGE_2, Dr. Neal gave PSI a right of first refusal on any products he developed in the field.

In late 1997, Dr. Neal presented PSI with a product he had developed and was testing under a physician's IND.[1] This product was a combination of PGE_2 and a dehydrogenase inhibitor (oleic acid) and was designed to be inserted into the meatus (tip) of the penis where it would dissolve at body temperature, be absorbed into the body, migrate to the base of the penis and produce an erection sufficient for vaginal penetration. The theory behind the use of an inhibitor was that, although PGE_2 is a potent vasodilator, it is quickly broken down by enzymes. Thus, if this breakdown could be prevented or delayed, the PGE_2 could be used to induce an erection even when administered in the relatively remote site, such as the tip of the penis. Since this concept did not involve a transdermal injection or the use of any mechanical device for inserting the product deep into the urethra, PSI thought

[1] A physician's IND (investigational new drug) allows a physician to treat patients under a specific protocol. In the present case, Dr. Neal's protocol was to treat patients using the drug Dinoprostone without the use of any inhibitors.

it would be an attractive alternative to other non-systemic therapies then available on the market.[2]

Although PGE_2 was an approved drug, it had never been approved for the treatment of ED. In addition, the combination of PGE_2 with a dehydrogenase inhibitor had never been approved for any purpose. Nevertheless, the record shows that PSI initially regarded the inhibitor to be classified as "GRAS," i.e., generally accepted as safe.[3] Also, "because there was experience using [PGE_2] in cervical ripening . . . the regulatory pathway would be easier. "[4] While the regulatory barriers confronting the ED Product were not "insignificant," PSI expected that process to be "much easier than starting with a new chemical entity . . . . "[5]

At its meeting held on December 10, 1997, the PSI board of directors expressed a favorable view of management's proposal to pursue the

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[2] Systemic drugs such as Viagra affect the entire systemic circulation of the body. Unlike systemic drugs, locally acting drugs such as the ED Product are designed to affect a specific part of the body without causing systemic reactions or side effects.

[3] Willson testified that, based on Dr. Neal's representations, he initially classified the inhibitor as GRAS. Willson further stated that his initial classification changed when Affiliated Research Centers, a clinical trials organization, informed him that combining the inhibitor with Dinoprostone presented a substantial risk and would be required by the FDA to undergo extensive preclinical testing.

[4] Trial transcript ("Tr.") at 400.

[5] Tr. at 400.

development of the ED Product and instructed them to develop a clinical plan with cost estimates, for presentation at the next meeting. Thereafter, management developed such a plan and presented it to the PSI board at its April 14, 1998 meeting, at which the directors were told that the ED Product had passed a "preliminary efficacy test? The PSI directors approved a licensing agreement with AndroSolutions and agreed to convey an initial payment of $200,000 to AndroSolutions. The board also authorized a budget of approximately $750,000 (including licensing fees) to see the project through the proof-of-principle stage, estimated to continue through the first quarter of 1999. The licensing agreement was signed on July 9, 1998. Under its terms, PSI would have to make a second payment of $400,000 to AndroSolutions on its first anniversary, unless it decided to terminate the contract, in which case it could avoid the payment.

PSI conducted a double-blind, randomized, placebo-controlled Phase I clinical trial for the ED Product in the first quarter of 1999. The results of this testing were inconclusive. Further work was done in March and April

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[6] This may refer to the fact that several officers of PSI and others at Controlled Therapeutics (Scotland) Ltd. ("CTS"), a subsidiary product development and manufacturing facility, were given samples to the product to try on themselves.

1999 to understand those results, including a meeting held at CTS's laboratories in Scotland with Dr. Neal. The results of those meetings are summarized in a series of reports prepared by J. A. Halliday, a scientist employed at CTS. In summary, the reports relate that CTS was unable to formulate a product with the same clinical effects as those reported by Dr. Neal.

This report was discouraging to PSI management, but they did not abandon their efforts to find a solution to the problem because the potential financial rewards of a successful ED Product were so great. As of the effective date of the Merger, the board of directors had not decided whether to make the next $400,000 payment to AndroSolutions or to pull the plug on the project.

c. The Merger

Beginning in the spring of 1996, the management and major stockholders of PSI began active consideration of an exit strategy. The possibilities considered included (a) an outright sale of the Company, (b) a merger with another company which was either publicly traded or had the prospects of going public; and (c) development of new products, which would lead to an IPO or increase the value of the Company for sale or merger.

Later in 1996, PSI's management had discussions with representatives from Forest Laboratories concerning a possible sale of the Company. Representatives of Forest prepared a financial analysis, which concluded that PSI had a net present value of $27 million. PSI's management, however, found the analysis to be flawed because it did not consider any value for new products. Consequently, PSI's board rejected the offer from Forest.

PSI's management also considered a proposal by the investment firm of Volpe Welty & Co. to sell the Company. Volpe Welty advised the PSI board that the sale price of the Company should range between $35 and $45 million, although a higher price could be obtained if an active bidding auction occurred. Picower, however, concluded that at $35 to $45 million, he would rather keep the Company than sell it. At this time, there was general agreement among the PSI board that the Company should be valued in the range of $60 million.

In 1997, Access Pharmaceuticals-a company run by Petitioner Gray—offered $45 million for PSI, subject to due diligence and financing. Access later increased its offer to $51 million. In correspondence between Gray and PSI, Gray maintained that investment bankers for Access considered the $51

million offer to be a premium price based on a discounted cash flow ("DCF") models and payback analysis.

While the Access offer was pending, PSI's management also explored a merger with CNI, which was also controlled by Picower. In connection with those discussions, Lehman Brothers was retained to value PSI in April 1997. Using financial projections prepared by PSI's management that did not quantify new business opportunities, Lehman Brothers valued PSI at $64 million. One of the exercises performed by Lehman Brothers was a DCF analysis of the projected stream of earnings attributable to the cervical ripening product. This DCF analysis produced a valuation range with a midpoint of $83 million.

In mid-1998, PSI's management estimated the value of the Company at $49.4 million without new products and $129.6 million with new products. CPSI now contends that the projections used to support these valuation exercises were inaccurate because they did not take into account the probability that some or all of the new products would fail. In other words, CPSI argues that the projections prepared by PSI management were not meant to reflect management's best estimate of the future performance of the Company.

In 1999, PSI's management met with representatives of CNI and decided to merge on a stock-for-stock basis. MMV, which owned approximately 39% of PSI's common stock, was opposed to the Merger because MMV was about to liquidate and could not distribute unregistered securities to its investors. Under the stockholders' agreement, MMV had the right to block a merger. In return for liquidity, however, MMV was willing to sell its interest in PSI at a discount from fair value. PSI repurchased MMV's interest at a price of $266 a share,[7] a price that PSI Chief Executive Officer later described as a "steal."

After negotiating a 60:40 ratio (PSI to CNI) for the Merger, both parties deemed it necessary to obtain a fairness opinion. After pricing such an opinion, however, the parties decided to save money by asking Merrill Lynch to value the stock of both companies, without opining as to fairness. Accordingly, Merrill Lynch was engaged to determine the fair market value of PSI and CNI for a proposed merger of the two companies.

The Merrill Lynch valuation derived the-following equity range values for PSI:

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[7] At a price of $266 per share, PSI had an implied value of approximately $25 million at the time it repurchased MMV's shares.

Approach	Equity Range Value	Midpoint
Discounted Cash Flow	$66.5 - $126.6 million	$96.5 million
Public Market	$65.6 - $79.3 million	$72.5 million
M&A Transactions	$75.6 - $100.5 million	$88.1 million

In its DCF analysis, Merrill Lynch applied a blended discount rate of 40% to 50% to management's financial projections, i.e., a lower rate was used for the product already on the market and a higher rate for the pipeline products. At the time of the valuation, PSI's management took issue with the discount rate used by Merrill Lynch and contended that it should be significantly lower.[8] Merrill Lynch did not agree and stuck to the higher discount rates.

In this appraisal action, CPSI takes the position that the Merrill Lynch valuation is entirely irrelevant because, it claims, Merrill Lynch supposedly did not value either PSI or CNI as a going concern on a stand-alone basis. Rather, Respondent claims that management sought only a relative valuation from Merrill Lynch in order to confirm that the proposed allocation of 60% PSI and 40% CNI was justified for purposes of the Merger.

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[8] This is not surprising because at the time the Company's financial projections were submitted to Merrill Lynch, PSI management possessed a significant percentage of PSI common stock and it was in their best interest to obtain a high valuation of PSI. This would provide management a greater ownership interest in the newly formed CPSI.

D. The Experts

Gray's trial expert was Jeffrey B. Davis, President of Small Caps Online Group, LLC ("SCO"). SCO is a boutique communications and investment banking firm that provides financial services to small-cap health care and information technology companies. Davis earned an M.B.A. from the Wharton School of Business of the University of Pennsylvania. His experience includes service as a Senior Vice President and CFO of a publicly traded development stage healthcare technology company, and a position as Vice President, Corporate Finance at Deutsche Bank. Davis had never before served as an expert in any judicial proceeding. Gray retained Davis in this matter because of his expertise in the emerging pharmaceutical marketplace. Gray was familiar with Davis because of services SCO provided to Gray as President and CEO of Access Pharmaceuticals.

Davis relied entirely on a DCF analysis to value PSI, testifying that other approaches normally used to value companies were not useful in valuing PSI.[9] Davis's DCF analysis was based on the projections prepared by PSI's

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[9] Davis also conducted a comparable companies analysis and a comparable M&A transactions analysis. For reasons discussed hereafter, he concluded that neither approach was appropriate in valuing PSI and that fair value is best characterized by the DCF analysis.

management and given to Merrill Lynch. Davis claims that these projected revenues, earnings and cash flows were discounted using discount rates commensurate with other drug delivery companies. Davis's DCF analysis ultimately resulted in a valuation with a midpoint of $192.5 million, or $3,330 per share.

Respondent's expert witness was J. Mark Penny of Hempstead & Company. Penny is an accredited senior appraiser in the American Society of Appraisers with a specialty discipline of business valuation. Penny has conducted approximately one thousand business valuations, including ten in the pharmaceutical industry and two in the drug delivery business.

In determining the fair value of PSI common stock, Penny used a DCF analysis and a guideline company analysis. Based on the DCF analysis, Penny determined that the fair equity value of the Company was $36.7 million. Based on the guideline company analysis, Penny concluded that the fair equity value of the Company was approximately $35.9 million. Weighing these nearly identical results equally, Penny found that the fair value of PSI common stock at the time of the Merger was $36.4 million, or $383 per share. Penny subsequently adjusted this valuation to reflect the fact that MMV shares were not outstanding at the time of the Merger, having been

purchased for $10 million cash. After making this adjustment, Penny concluded that the fair equity value of the Company was $26.5 million, or $458 per share.

III. Analysis

Under Section 262 of the DGCL, Gray is entitled to his ***pro rata*** share of the fair value of PSI's common stock at the time of the Merger. Fair value, as used in Section 262(h), has been defined as "the value of the Company to the stockholder as a going concern, rather than its value to a third party as an acquisition. "[10] Furthermore, Section 262(h) directs this court to calculate the going concern value "exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation. "[11]

As is all too often the case, the parties' experts examined PSI's operations and assets at the time of Merger, analyzed the corporation's financial performance, both historical and projected, and came up with enormously disparate conclusions as to its value. Penny, for the Respondent, concluded that PSI's going concern value was only $26.5 million and, thus,

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[10] ***M.P.M. Enterprises, Inc. v. Gilbert,*** 731 A.2d 790, 795 (Del. 1999); see ***also Cede & Co. v. Technicolor, Inc.,*** 684 A.2d 289, 299 (Del. 1996) (failure to value the company as a going concern may result in an understatement of fair value).

[11] 8 ***Del. C.*** § 262(h).

Gray was entitled to approximately $271,136 for his shares. Davis, for the Petitioner, arrived at a value of $192.5 million for the Company and approximately $1,971,360 for Gray's shares. Obviously, the underlying assumptions that drive these valuations must be tested to ensure that all relevant facts are properly and reasonably considered.'* Just as obviously, I must examine the circumstances surrounding the preparation of these valuations to determine whether or not they are credible or reliable.

Fortunately, I have the benefit of an independent valuation performed by Merrill Lynch in connection with the Merger.[13] PSI management used the Merrill Lynch valuation to justify a favorable exchange ratio for its shareholders in the Merger. Moreover, the record fully justifies the conclusion that PSI's management and board of directors accepted the Merrill Lynch analysis and valuation as substantially accurate for purposes of approving that transaction. In this litigation, CPSI chose to retain Penny's

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[12] ***Gilbert v. MPM Enterprises, Inc., 709*** A.2d 663, 667 (Del. Ch. 1997).

[13] The benefit of having an independent expert was recognized in ***Gilbert,*** where then Vice Chancellor (now Justice) Steele noted in footnote 8: "This clear tendency of experts to provide an extreme value most favorable for their client encourages disagreement in every area of the proceeding. Weighing of these numerous minor areas of conflict, and not necessarily the interpretation of financial models, is perhaps the best reason for this Court to consider appointing an independent expert to sort through the clutter submitted. " Id. at 667 n.8.

firm, rather than Merrill Lynch, to act as its expert witness. Penny arrived at a valuation more than 50% lower than Merrill Lynch. To explain this significant variance, CPSI tries to undermine the reliability of Merrill Lynch's work as a measure of going concern value. The arguments it makes are discussed and rejected below. [14] I find that the Merrill Lynch valuation is both reliable and highly probative of the going concern value of PSI and will rely on it in appraising the shares at issue.

A. Petitioner's Valuation Expert

Davis prepared a DCF analysis, a comparable companies analysis and a comparable Mergers & Acquisitions transactions analysis. The reliability of Davis's entire valuation is undermined for several reasons. First, more than a year before the Merger, Gray retained Davis to serve as a financial consultant and advisor to Access Pharmaceuticals. At that time, Gray was President and CEO of Access and regularly consulted with Davis in connection with financial advisory issues and investor relations needs. In exchange for his services, Davis received substantial monthly cash payments and warrants to

[14] Petitioner also relies on the Merrill Lynch valuation in his post-trial reply brief, more or less to the exclusion of his own trial expert whose report and opinion were both easily attacked.

purchase Access stock. Furthermore, Davis admitted that he agreed to serve as an expert in this action, a role that he never previously performed, due to his relationship with Gray. These facts substantially undermine Davis's ability to act independently of Gray.

Second, Davis's valuation report contained several errors. In his DCF analysis, Davis included interest income in his projection of free cash flows" and applied an inappropriately low discount rate to PSI's future cash flows? These errors resulted in a substantial over-valuation of the Company and further undermine the reliability of Davis's DCF analysis.

Finally, Davis's valuation reached conclusions as to value that are so high that they draw into question both his qualifications and his independence. Compared to the valuations conducted by Merrill Lynch and Lehman Brothers, Davis's valuation is off the charts. As stated above, the Merrill Lynch analysis produced a valuation with a midpoint of $87.5 million. On par with the Merrill Lynch analysis, Lehman Brothers' April 1997 DCF

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[15] Davis incorrectly assumed that interest income would be retained by the Company and not distributed to shareholders. Unlike Penny and Merrill Lynch, Davis failed to make any adjustments to the interest income projections, thus resulting in a substantial overvaluation.

[16] Davis's comparable companies analysis also contained several errors. I will not delve into the specifics of those errors because Gray conceded that the methodology used in the comparable companies approach was not useful in the present context.

analysis valued PSI at approximately $84 million. Davis's valuation, which produced a going concern value of $192.5 million, more than doubles the results reached by Merrill Lynch and Lehman Brothers.

Davis's going concern value is also more than four times higher than any offer PSI's board received when attempting to sell the Company. In 1996, PSI's board rejected a $27 million offer from Forest Laboratories. At about the same time, Volpe Welty & Co. advised PSI's board that the sale price of the Company should range between $35 and $45 million. In 1997, Access Pharmaceuticals offered to purchase PSI for $51 million. The extraordinary variance from these indications of value is unexplained.

In sum, when compared to other indications of value, Davis's valuation is such an outlier that it casts doubt on its reliability, quite apart from its exact assumptions and methodologies. Given its "outlier" status, Gray and Davis had an obligation to explain the extreme variation from the pack. Because they failed to do so, and because of Davis's lack of independence, I will not rely on Davis's valuation.

B. Respondent's Valuation

Respondent's expert, Penny, included a DCF analysis and a comparable companies analysis in his valuation. For reasons discussed below, I also find Penny's entire valuation to be unreliable.

1. Discounted Cash Flow Approach

In preparing his DCF analysis, Penny completely disregarded the cash flow projections that were prepared by PSI's management and relied on by Merrill Lynch. Instead, Penny made his own projections. He did so by assuming a constant rate of growth over PSI's 1998 revenues (10 % in one case and 20 % in the other). Penny also eliminated all projected earnings from new products.

In formulating his own projections for PSI, Penny endorsed CSPI's argument that management's prior forecasts were merely "what if' scenarios used to assist the board in considering various funding options. I cannot agree. Considering the type of industry PSI is in, management projections will inevitably contain "what if" scenarios. This is primarily due to the inherent difficulty involved in predicting when a pipeline product will gain FDA approval and how much of a market share an approved product will capture. Nevertheless, PSI's management presented these forecasts to Merrill

Lynch to determine the fair market value of PSI and CNI for a proposed merger of the two companies. In fact, Willson testified that his projections were based on detailed information and were conservatively prepared. Certainly, CPSI presented no evidence suggesting that Merrill Lynch was told that the financial forecasts it was given were mere "management tools" that did not accurately reflect PSI's future cash flows.

Aside from disregarding management's revenue projections, Penny also ignored management's projections in several other respects. Specifically, Penny increased management's projected General and Administrative expenses from 5 % to 10%; increased management's projected Cost of Goods Sold and Royalties from 37.6 % of sales to 50% of sales; and increased the tax rate to 40 % from management's projected 35 % . Penny did not provide valid reasons to warrant all of these adjustments. In sum, I cannot accept that Penny, with his limited experience with the Company, was better equipped to make future financial projections than PSI's management. Consequently, I find Penny's litigation-driven projections to be unreliable and, thus, disregard his DCF analysis. Any other result would condone allowing a company's

management or board of directors to disavow their own data in order to justify a lower valuation in an appraisal proceeding. [17]

I also find that Penny's DCF is so heavily dependent on the determination of PSI's terminal value that the entire exercise amounts to little more than a special case of the comparable companies approach to value and, thus, has little or no independent validity. [18] This is easily seen from the fact that Penny's discounted terminal value calculations equal or exceed 75 % of the total discounted cash flow value of the enterprise in the lowest case and 85 % or more in the other three cases presented. Thus, it is hardly surprising that there is a tight fit between the results Penny derives from the DCF ($36.7 million) and that from the comparable companies approach to value ($35.9 million). In the circumstances, this is an added reason not to rely on Penny's DCF analysis in valuing PSI.

2. Comparable Companies Approach

Penny's comparable companies approach is also unreliable for several, different, reasons. First, the comparable companies used by Penny were

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[17] ***Cavalier Oil Corp. v. Hamett,*** Del. Ch., C.A. No. 7959, slip op. at 49, Jacobs, V.C. (Feb. 22, 1988), *aff'd*, *564* A.2d 1137 (Del. 1989).

[18] Terminal value is calculated by multiplying terminal year revenues or EBIT by figures derived from Penny's examination of comparable companies.

much larger than PSI both in terms of revenue and market capitalization.[19] Second, of the ten comparable companies utilized by Penny, only one was in the drug delivery business. This court has found that the "utility of the comparable company approach depends on the similarity between the company the court is valuing and the companies used for comparison.""[20] Where there is a "lack of comparable companies," the analysis is not "particularly meaningful" and should not be used.[21] Since Penny's comparable companies were not in the drug delivery business and were on average much larger than PSI, I find that they are dissimilar from PSI. As a result, I find Penny's comparable companies analysis to be unreliable.

c. The Merrill Lynch Valuation

The valuation done by Merrill Lynch is a reliable depiction of the fair value of PSI at the time of the Merger. Merrill Lynch was a disinterested party at the time it prepared its valuation. Unlike the litigation-driven models prepared by each party's expert witness, the Merrill Lynch valuation was

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[19] The comparable companies taken together had a market capitalization with a median 24 times higher than PSI. The median revenue of the comparable companies was 12 times larger than PSI.

[20] ***In re Radiology Assoc., Inc. Lit.,*** 611 A.2d 485, 490 (Del. Ch. 1991).

[21] ***Kahn v. Household Acquisition Corp., 591*** A.2d 166, 175 (Del. 1991). .

prepared shortly before the Merger at a time when Merrill Lynch had no incentive to artificially inflate or shrink the value of PSI.

CPSI argues that the Merrill Lynch valuation should be set aside because it does not represent the fair value of PSI as a going concern on a stand-alone basis. CPSI contends that the Merrill Lynch valuation was done only to determine the relative values of CNI and PSI-not their absolute values-in connection with a possible stock-for-stock merger. In support of this contention, CPSI cites deposition testimony elicited from Kit A. Kamholz, lead analyst in the Merrill Lynch valuation. At his deposition, Kamholz testified that the projections used in his DCF valuation do not take into account the risk that the ED Product would never be approved. Kamholz further testified that, had he valued PSI as a going concern on a stand-alone basis, he would have adjusted management's financial projections to reflect the increased risk associated with the "stage of development the client was in." Kamholz repeatedly stated that he took management's financial projections at face value and did not discount the projections to reflect the possibility that the pipeline products would never reach the market.

If this were true, it would, of course, undermine the reliability of the Merrill Lynch DCF analysis. However, Kamholz's deposition testimony on

this matter contradicts what is actually stated in the Merrill Lynch valuation report. When discussing the discount rate applied to management's projected cash flows, the valuation report states:

> Discount rates for development stage companies in the biopharmaceutical/biotechnology industry typically range from 35 % to 70%. The discount rate appropriate for a particular company depends upon factors including:
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> - ***Stage of development for the company 's product pipeline (i.e., Preclinical, Phase I, Phase II, Phase III) and the probability of developing these products successfully.***
> - Diversification of the product pipeline/portfolio.
> - Level of competition within the targeted market(s).
> - Existence of collaborations and/or partnerships with large drug companies.
> - Outlook for and existence of commercially launched products by the company.
> - Management depth and other qualitative factors.
>
> Given these considerations and other factors specific to PSI, Merrill Lynch applied discount rates of 40 % to 50% to PSI'S forecasted cash flows. (Emphasis added.)

The italicized portion of the Merrill Lynch report directly contradicts Kamholz's testimony. It is quite clear that the large discount rate applied by Merrill Lynch to PSI's projected cash flows takes into consideration the possibility that the Company's pipeline products will never reach the market.

Moreover, the thrust of CPSI's argument is undercut by other parts of Kamholz's testimony. At his deposition, Kamholz stated that Merrill Lynch's

valuation approach would not have changed if the Merger were a *stock-for-cash* merger as opposed to a stock-for-stock merger. He clarified this statement by agreeing that if the Merger involved Cytokine shareholders receiving stock and PSI shareholders receiving cash, his valuation method would have been the same. The obvious implication of this testimony is that Kamholz and Merrill Lynch did not merely perform a comparative valuation but, instead, applied normal valuation techniques as they would in any valuation assignment.

1. Discounted Cash Flow Approach

In its DCF analysis, Merrill Lynch applied a range of discount rates to PSI's projected cash flows. As noted above, the discount rates took several factors into consideration, including the stage of development of the products in the Company's pipeline and the probability of developing those products successfully. Ultimately the discount rates applied to PSI projected cash flows ranged from 40% to 50%.

Merrill Lynch also placed a value on PSI beyond the forecast period by applying a range of multiples of revenue to projected revenues in 2008. Based upon market valuations for publicly traded companies similar to PSI, a range of revenue multiples from 4.0x to 6.0x was selected. The terminal

value was then discounted to the present and added to the present value of projected cash flows from 1999 to 2008.

Applying different variations of discount rates and terminal multiples leads to drastically different results. At the low end of the spectrum, applying a 50 % discount rate and a terminal multiple of 4.0x would lead to a valuation of approximately $66.5 million. At the high end of the spectrum, applying a 40% discount rate together with a terminal multiple of 6.0x would result in an approximate valuation of $126.5 million.

I find that PSI's projected stream of future cash flows should be discounted at 50%. As stated above, the Merrill Lynch valuation was completed in May of 1999. Consequently, the discouraging results of meetings conducted at CTS on June 9 and 10, 1999 were not considered in Merrill Lynch's analysis. The results obtained decreased the likelihood that the ED Product would successfully enter the market. The results, however, did not indicate that the ED Product would ***never*** reach the market. If this were the case, PSI management would certainly have informed Merrill Lynch that its financial projections were inaccurate, which would render the previously deduced merger ratio invalid. Because PSI's board never informed Merrill Lynch of the "new" information obtained at the CTS meeting, I will

account for that discouraging information by applying the high end (50%) of the range of discount rates applied by Merrill Lynch.

I also find that a revenue multiple of 4.0x should be applied to PSI's projected revenues in 2008 to determine most accurately the Company's terminal value. At the time of the Merger, PSI was in a strong financial position and it had no long-term debt on its balance sheet. Furthermore, it had a very successful product that had captured over 85 % of the United States market and was scheduled to launch in markets all over the globe. Nevertheless, a substantial part of PSI's future revenues hinged on the success of the ED Product. Taking into consideration the discouraging results of the CTS meeting, I find that applying a low revenue multiple of 4.0x will best reflect PSI's terminal value.

Applying a 50% discount rate to PSI's projected cash flows together with a terminal multiple of 4.0x results in an enterprise value of approximately $66.5 million. The enterprise value must be adjusted because Merrill Lynch's DCF valuation did not include interest income on any cash or cash equivalents or interest expense on any debt. As a result, the Company's cash or cash equivalents should be added to the Company's enterprise value. Conversely, any interest-bearing debt should be deducted from the Company's

enterprise value. As of June 30, 1999, the Company had cash and investments of $8.7 million and no interest-bearing debt. Adding $8.7 million to the Company's enterprise value results in a derived value of $75.2 million. Consequently, I find that based on a DCF analysis, PSI's going concern value at the time of the Merger was $75.2 million.

2. Comparable Companies Approach

Merrill Lynch's comparable companies analysis also reliably depicts the fair value of PSI at the time of the Merger? Using this approach, Merrill Lynch analyzed market capitalization and market value multiples for publicly traded biotechnology and biopharmaceutical companies that focused on drug delivery technology. Aside from focusing on drug delivery companies, Merrill Lynch took other precautions to ensure that the comparable companies were sufficiently similar to PSI. It excluded companies with revenues greater than $150 million and also left out companies with no commercially launched products on the market. In the end, Merrill Lynch found five companies that focused on drug delivery, were of similar size, and had products in similar

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[22] This comparable companies analysis was prepared when Merrill Lynch worked for both PSI and CNI. Consequently, there was no bias in the assignment and Merrill Lynch had no incentive to artificially inflate or shrink the value of PSI. Moreover, Respondent's criticism of the Merrill Lynch valuation appears to be directed solely at the DCF analysis.

stages to that of PSI. Based on multiples derived from the comparable companies, Merrill Lynch determined that PSI's enterprise value ranged from $57,843,000 to $71,482,000.[23] I will use the midpoint of this range, which is $64,662,500. Similar to the DCF analysis, the enterprise value deduced from the comparable companies analysis must be adjusted to reflect PSI's cash or cash equivalents and interest-bearing debt as of June 30, 1999. Adding $8.7 million results in a derived value of $73,362,500.[24]

Merrill Lynch's DCF and comparable companies analyses were both reliable measures of going concern value. As such, I will average their results, which leads to a going concern value of $74,28 1,250. This value must be adjusted to reflect the repurchase of MMV's substantial holdings of PSI's common stock. MMV's 37,200 shares of common stock were repurchased by the Company immediately prior to the merger for $9,899,204. The purchase price of $9,899,204 is subtracted from the going concern value

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[23] The enterprise value of $57,843,000 was determined by applying a multiple of 6.63x to PSI's revenues in the twelve months ending April 27, 1999. Ideally, the revenue multiple of 6.63x should be multiplied by PSI's LTM revenues ending June 30, 1999, however, neither party has presented that figure to the court. The enterprise value of $71,482,000 was determined by applying a multiple of 14. lx to PSI's projected 2000 Net Income.

[24] Merrill Lynch did not adjust this result by applying either a control premium or an illiquidity discount. Neither party challenges this approach.

of $74,28 1,250, which yields an adjusted fair equity value of $64,382,046. Reducing the shares issued and outstanding to 57,800 and dividing that number into $64,382,046 yields a per share value of $1,114.

D. Post-Merger Interest

Section 262(i) of the DGCL provides in pertinent part that after appraising the shares:

> The Court shall direct the payment of the fair value of the shares, together with interest, if any, by the surviving or resulting corporation to the stockholders entitled thereto. Interest may be simple or compound, as the Court may direct.

Both parties agree that interest should be awarded at the compound rate of 8.3 1% . They disagree, however, on the proper compounding interval. Relying on several recent decisions of this court, Gray contends that interest should be compounded on a monthly basis? Gray also bases this conclusion on the fact that PSI loaned funds to CNI a few months prior to the Merger at a

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[25] See *Onti, Inc.* v. *Integra Bank,* Del. Ch., Consol. C.A. No. 14514, Chandler, C., slip op. at 51 (May 26, 1999) (awarding interest compounded monthly); *Grimes v. Vitalink Communications* Corp., Del. Ch., C.A. No. 12334, Chandler, C., slip op. at 39 (Aug. 26, 1997) ("the dual purposes of compensation and restitution may only be served by a compounding interval at least as frequent as one month"), *aff'd, 708* A.2d 630 (Del. 1998); *Hintmann* v. *Fred Weber,* Inc., Del. Ch., C.A. No. 12839, Steele, V.C., slip op. at 33 (Feb. 17, 1998) (awarding interest "adjusted and compounded monthly").

rate of 10 % compounded monthly. I agree with Gray and find that in the present context it is appropriate to compound interest on a monthly basis.

E. Fees and Expenses

Section 262 of the DGCL provides that "[t]he costs of the [appraisal] proceeding may be determined by the Court [of Chancery] and taxed upon the parties as the Court deems equitable in the circumstances. "[26] This statute was interpreted in Cede ***& Co. v. Technicolor,*** where the Delaware Supreme Court stated, "[i]n the absence of an equitable exception, the plaintiff in an appraisal proceeding should bear the burden of paying its own expert witnesses and attorneys. "[27]

Gray relies on the argument that CPSI proceeded in bad faith, for two reasons. First, Gray argues that Penny's valuation is equivalent to the MMV repurchase price, which Storm described as a "steal." Second, Gray argues that he demanded appraisal in reliance on the Merrill Lynch analysis that was provided to him by PSI management in connection with the Merger. As such, Gray contends that Respondent's disavowal of the Merrill Lynch valuation is "unprincipled" and "inequitable. " Gray's first point is simply incorrect. The

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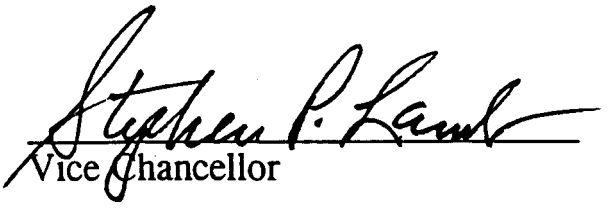
[26] 8 *Del. C.* § *262(j).*

[27] 684 A.2d 289, 301 (Del. 1996).

MMV repurchase price and the per share value deduced by Penny were not "equivalent. " Penny's valuation of $458 per share was significantly higher than the $266 repurchase price offered to MMV. Gray's second point is closer to the mark but, ultimately, unpersuasive because Gray did not rely on the Merrill Lynch analysis in this litigation. Instead, he obtained and tried to persuade the court to adopt the work of his own ill-qualified and unreliable expert. In sum, I fmd that Gray has failed to prove an equitable exception and, thus, he should bear the burden of paying his own expert witness and attorney's fees.

IV. Conclusion

For all the foregoing reasons, I determine that the fair value of each share of PSI's common stock, as of the date of the Merger, was $1,114 and, thus, will enter an order awarding Petitioner a total of $659,488 plus interest at the rate of 8.3 1% , compounded monthly. The parties are directed to present an order of final judgment in conformity with this opinion within 10 days of this date.



Vice Chancellor