INDEPENDENT IMMUNITIES

NEGOTIATION

General and Prometheus Pharmaceuticals Information

General Information

Not long ago, Prometheus Pharmaceuticals International adopted a strategic business plan to concentrate on developing and marketing higher-profit drugs. The aim is to maintain high stock prices and increase funding for expensive R&D for new drugs. Prometheus will discontinue production of lower profit margin drugs that benefit only smaller patient populations.

One drug to be discontinued is Immuno-Pure ("Pure"), which boosts the immune system in immune-deficient patients. Pure uses an extremely pure, costly manufacturing process. Though Pure is priced high, its profit margin is modest. Prometheus will expand production of its other similar drug, Immuno-Plus ("Plus"). Plus uses a far less expensive manufacturing process and thus will yield higher profits than Pure. Most of the patient population tolerates both drugs well. However, a minority of patients develop debilitating headaches and nausea from the less expensive Plus. Most insurers will only pay for Plus, absent physician verification of a patient's serious adverse reaction.

A month ago, Prometheus authorized the Pure marketing team to announce that production of Immuno-Pure would cease within the next few months so that customers could stock up. Since then, Prometheus has received many entreaties from Pure patients to reconsider the decision, because they fear painful and debilitating reactions to the Plus drug. There is no other source of Pure.

In response, a group of five Prometheus scientists and business managers announced that they would like to leave Prometheus to launch their own company, Pure Health, committed to producing Pure. However, they know that Prometheus holds patents on both Pure and its distinctive manufacturing process and that they are bound by Prometheus's standard non-compete agreements. Two weeks ago, Pure Health approached Prometheus about the idea, emphasizing that unless the Pure Health group were permitted to produce Pure, some patients would suffer terribly and needlessly. Prometheus indicated that it was open to discussing a deal. Last week, representatives met and agreed upon the following basic elements of a deal:

- The transaction would be structured as an exclusive licensing of the Pure process and manufacturing patents, with royalties to be paid to Prometheus by Pure Health. Prometheus would have preferred a non-exclusive license, but this was a deal breaker for Pure Health. Prometheus ultimately agreed the license would be exclusive.
- The Pure Health team would be released from their current non-compete agreements, which extend to intravenous pharmaceutical products manufactured by Prometheus.

- Prometheus has agreed to continue manufacturing Immuno-Pure and to sell it to Pure Health at cost-plus 10%, for an interim period to be negotiated. The idea is to enable Pure Health to get its facility up and running.
- These issues will not be revisited in future negotiations about the terms of the deal.

At the end of their meeting, the parties agreed to meet again to see if they could work out additional major issues. This negotiation is about to take place.

Confidential Information for Prometheus Pharmaceuticals, Inc.

Prometheus' current strategic business plan is to concentrate on higher-profit drugs and drug delivery systems and to discontinue lower-profit margin drugs that benefit smaller patient populations. You have mixed feelings about the Pure Health proposal. On one hand, it would be a way for Prometheus to continue to earn returns on its intellectual property while pursuing its new strategy and to continue to service a vulnerable patient population. But, like any spin-off, Pure Health could potentially become a new competitor. Your views on Pure Health's intent will influence your willingness to make a deal or offer favorable terms.

Your first meeting was cordial and productive. The four additional major issues remaining for negotiation are discussed on the pages that follow. You have arrived at a scoring system for possible results on these issues. This scoring system is intended to help you decide how to trade off or compromise on issues to get maximum benefit.

Royalty Percentages

Based upon experience, you assume that Pure will generate approximately $20 million in gross sales revenues per year, with a 20% or $4 million profit margin per year (before royalties), when using current manufacturing methods. Royalties would be calculated based on gross sales revenues. Thus, a 5% royalty per year on $20 million in sales, would cost approximately $1 million and would reduce the profit margin from $4 million to $3 million.

In simple terms, Prometheus should want the highest possible royalty, and Pure Health should want the lowest possible royalty. Reality is *never* that simple. If Pure Health ends up paying too high a royalty, it may create political difficulties for you, because it calls into question Prometheus' original decision to discontinue Pure. While you would like to get a royalty in the 5-7% range, you would be willing to entertain a royalty as low as 2%, as part of a larger package, particularly if Prometheus can benefit from future improvements that Pure Health might make in manufacturing processes (see issue 2 below). You know that the royalty percentage on Pure is found money to Prometheus.

The points you will achieve at various possible royalty levels are set out in the Scoring Guide at the end of this sheet.

Unilateral or Shared Rights to Improvements

A second issue for negotiation will be whether Pure Health will have the right to keep (unilaterally) or benefit from any improvements it makes to the Pure product, such as derivative vaccines. You feel strongly that sharing future improvements is the best way for Prometheus to reap from past investments, and to expand its future R&D capacity, as spin-offs become satellite labs. You also consider Pure Health's position on this issue as an indication of whether they will be a Prometheus friend or enemy in the future. With that in mind, here is how you view these options.

- Giving Pure Health the unilateral rights to sell all improvements with no payment to Prometheus. This option is not technically a deal breaker, but you strongly oppose it as enabling future competition.
- You would prefer that Prometheus retain some interest in improvements, with an agreement that:
  - Gives Prometheus a right of first refusal to purchase or license back any improvements Pure Health makes in the product and manufacturing process at a fair market price, or
  - Gives Prometheus shared right to improvements Pure Health may develop, at no cost to Prometheus.

Point totals for options (a), (b), and (c) are set out in the Scoring Guide.

Marketing VP and Waiver of Non-Compete

You understand that Pure Health hopes to get Donna Michaels, a Prometheus Marketing Director. Michaels is smart, but she has alienated many key Prometheus people, causing high turnover in marketing. You would be delighted to lose her. Because Michaels is Prometheus' senior management, her non-compete agreement is broader than that of others on the Pure Health team. Michaels' non-compete bars her from "marketing, strategy, analysis or management in any pharmaceutical company, or company that develops, produces or distributes products relating to pharmaceuticals in the U.S. for five years." You don't object to releasing her as to intravenous products, or even from the entire non-compete, as long as it is kept confidential.

(a) It would be best to get rid of Michaels while waiving her non-compete only as to intravenous drugs.
(b) Another option is to waive her non-compete entirely, with a confidentiality arrangement.
(c) A third option is to waive entirely with confidentiality only after one year.

Point totals for options (a), (b), and (c) are set out in the Scoring Guide.

Length of Interim Production

You did agree that Prometheus would continue to produce Pure (and sell it to Pure Health at cost plus 10%) for *some* interim period because Pure Health will need time to get its new production facilities up and running. Since then, you have learned that Prometheus would like to adapt its Pure production area for one of two new products. Neither product will be ready for at least 6 months, but one may be ready for production within a year. It could be produced in a different plant, but that would require more expensive retooling than the Pure facility. If Pure production is not completed within 18 months, the facility could lie idle, a waste for Prometheus. The values of committing to various periods are set out in the Scoring Guide.

Bottom Line

If you cannot reach a deal worth at least **250** points, it is not worth it to Prometheus for the Pure Heath venture to proceed. Try to negotiate the best deal you can for Prometheus.

Scoring Guide – Prometheus

Royalties:

You will achieve the following points at various possible royalty levels:

Royalty %	2%	2.5%	3%	3.5%	4%	4.5%	5%	5.5%
Points	50	55	60	70	80	90	100	105

Royalty %	6%	6.5%	7.0%	7.5%	8.0%**+**			
Points	110	115	120	115	100			

Future Improvements

Unilateral right to at no cost to improvements	*deduct* 40 points from your score
Right of first refusal to Prometheus	60
Free license to Prometheus	140

Michaels Non-Compete

Limited waiver for intravenous products only	80
Complete waiver	70
Complete waiver after one year	75

Length of Interim Production

Six months	100
One year	80
Eighteen months	50
Two years	10

Your minimum required score to settle is 250 points.