IN THE COURT OF COMMON PLEAS OF PHILADELPHIA COUNTY
FIRST JUDICIAL DISTRICT OF PENNSYLVANIA
TRIAL DIVISION - CIVIL

GUY QUIGLEY, et al.,	:	DECEMBER TERM, 2011
Plaintiffs,	:	NO. 00409
v.	:	COMMERCE PROGRAM
TED KARKUS, et al.,	:	Quigley Etal Vs Karkus Etal-OPFLD
Defendants.	:	11120040900111

OPINION

In this shareholder derivative action, this Pennsylvania court must apply the corporate law of Nevada, which tracks the law of Delaware, not that of Pennsylvania.[1] The corporation at issue, ProPhase Labs, Inc., ("ProPhase") is headquartered in Doylestown, Pennsylvania, but was incorporated under Nevada law. Plaintiff, Guy Quigley, was the founder and CEO of ProPhase,[2] until he was ousted by the defendants in a contentious proxy fight in 2009, and he continues to be a very disgruntled shareholder.[3] Defendant Ted Karkus is the current CEO of ProPhase; defendant Robert Cuddihy, Jr. is the CFO and COO; and defendants Mark Burnett, Mark Leventhal, Mark Frank, Louis Gleckel and James McCubbin are members of the Board of Directors of ProPhase.

In this action, Mr. Quigley, acting derivatively on behalf of ProPhase, claims that since the defendants took over ProPhase, they have repeatedly breached their fiduciary duties to the

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[1] To make this Opinion more useful to a mostly Pennsylvania audience, the court will point out where the law of Pennsylvania and Nevada overlap and where they diverge.

[2] ProPhase was originally named "The Quigley Corporation." Its premier product is Cold-Eeze®.

[3] Mr. Quigley filed two federal actions around the time of the proxy fight in an attempt to stop defendants from taking over ProPhase (the "Federal Proxy Litigation"). He was unsuccessful in the Federal Proxy Litigation.

company and committed waste of corporate assets and other wrongful acts.[4] After completing court ordered discovery on the relevant issues,[5] defendants filed a Motion to Dismiss such derivative claims and the court held a hearing.[6] Basically, there are four sets of corporate decisions of which plaintiff complains. The court will apply Nevada law to each of them in turn to determine if plaintiff may prosecute derivative claims based on each such act.

I. Applicable Nevada Law.

Under Nevada law, "[d]irectors and officers, in deciding upon matters of business, are presumed to act in good faith, on an informed basis and with a view to the interests of the corporation."[7] This presumption is commonly called "the business judgment rule" and it insulates directors from liability to shareholders and others for their decisions, subject to certain limitations.[8] One type of business judgment directors are often called upon to make is whether the corporation should sue third parties or insiders for wrongful acts against the corporation.

> In managing the corporation's affairs, the board of directors may generally decide whether to take legal action on the corporation's behalf. Nonetheless, when the

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[4] Similar claims, brought by defendants against Quigley for activities that occurred before the proxy fight, while he was CEO of ProPhase, are currently pending in the Court of Common Pleas for Bucks County, where ProPhase is headquartered. Clearly, these litigants despise one another, but it is not clear what benefit will ultimately accrue to ProPhase from any of these suits, which are purportedly being litigated on its behalf.

[5] Discovery was limited to the following issues: whether the directors implicated in any alleged improper act were, or those who would consider a demand are, disinterested, independent, and entitled to the protections of the business judgment rule; and whether Mr. Quigley is an adequate representative plaintiff. *See* Order entered April 8, 2013.

[6] In lieu of the traditional hearing, the parties agreed to submit their evidence in paper form and make extensive oral argument before the court based on that evidence.

[7] Nev. Rev. Stat. § 78.138. Pennsylvania has a similar presumption. *See* 15 Pa. Cons. Stat. § 1715 ("Absent breach of fiduciary duty, lack of good faith or self-dealing, any act as the board of directors, a committee of the board or an individual director shall be presumed to be in the best interests of the corporation.")

[8] Pennsylvania also recognizes the business judgment rule. *See* Cuker v. Mikalauskas, 547 Pa. 600, 612, 692 A.2d 1042, 1048 (1997) ("The business judgment rule should insulate officers and directors from judicial intervention in the absence of fraud or self-dealing, if challenged decisions were within the scope of the directors' authority, if they exercised reasonable diligence, and if they honestly and rationally believed their decisions were in the best interests of the company.")

> board fails to appropriately act, individual shareholders may file a suit in equity to enforce the corporation's rights. Thus, so-called derivative suits allow shareholders to "compel the corporation to sue" and to thereby pursue litigation on the corporation's behalf against the corporation's board of directors and officers, in addition to third parties. But because the power to manage the corporation's affairs resides in the board of directors, a shareholder must, before filing suit, make a demand on the board, or if necessary, on the other shareholders, to obtain the action that the shareholder desires.
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> This demand requirement recognizes the corporate form in two ways. First, a demand informs the directors of the complaining shareholder's concerns and gives them an opportunity to control any acts needed to correct improper conduct or actions, including any necessary litigation. The demand requirement also acknowledges that the acts in question may be subject to ratification by a majority of the shareholders, thus precluding the necessity of suit. Second, the demand requirement protects clearly discretionary directorial conduct and corporate assets by discouraging unnecessary, unfounded, or improper shareholder actions. Thus, in promoting alternate dispute resolution, rather than immediate recourse to litigation, the demand requirement is a recognition of the fundamental precept that directors manage the business and affairs of corporations.[9]

In this case, Mr. Quigley has asserted claims for wrongdoing on behalf of ProPhase against its officers and directors and states that he should be excused from having to make demand upon them to sue themselves because any such demand would necessarily be futile.[10]

> [A] plaintiff challenging a business decision and asserting demand futility must sufficiently show that either the board is incapable of invoking the business judgment rule's protections (e.g., because the directors are financially or otherwise interested in the challenged transaction) or, if the board is capable of invoking the business judgment rule's protections, that that rule is not likely to in fact protect the decision (i.e., because there exists a possibility of overcoming the business judgment rule's presumptions that the requisite due care was taken when the business decision was made). Of course, since approval of a transaction by the majority of a disinterested and independent board usually bolsters the

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[9] Shoen v. SAC Holding Corp., 122 Nev. 621, 632-33, 137 P.3d 1171, 1179 (2006).

[10] *See* Complaint, ¶ 98(a)-(f). Demand futility may be asserted under Nevada and Delaware law, but not under Pennsylvania law. *Compare* Shoen 122 Nev. 621, 137 P.3d 1171, *to* Cuker, 547 Pa. 600, 614, 692 A.2d 1042, 1049 ("Delaware law permits a court in some cases ('demand excused' cases) to apply its own business judgment in the review process when deciding to honor the directors' decision to terminate derivative litigation. In our view, this is a defect which could eviscerate the business judgment rule and contradict a long line of Pennsylvania precedents.")

> presumption that the transaction was carried out with the requisite due care, in such cases, a heavy burden falls on a plaintiff to avoid presuit demand.[11]

In order to succeed on his claim that demand would be futile, Mr. Quigley must show that the directors involved are not disinterested and/or not independent or that they did not exercise due care.[12]

> [D]irectors' independence can be implicated by particularly alleging that the directors' execution of their duties is unduly influenced, manifesting a direction of corporate conduct in such a way as to comport with the wishes or interests of the person doing the controlling. A lack of independence also can be indicated with facts that show that the majority is beholden to directors who would be liable or for other reasons is unable to consider a demand on its merits, for directors' discretion must be free from the influence of other interested persons.[13]
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> [T]o show interestedness, a shareholder must allege that a majority of the board members would be materially affected, either to their benefit or detriment, by a decision of the board, in a manner not shared by the corporation and the stockholders.[14]
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> [T]he only reason to . . . excuse demand would arise when a board has acted outside of the business judgment rule's protection, or when the board would not be able to impartially consider the demand.[15]

For purposes of this court's analysis, it makes a difference whether the complained of acts or decisions were approved or made by the full board, by a committee of the board, or by management of the company because the court's analysis of whether demand may be excused in each instance is slightly different. Where the challenged decision was made by the Board, Mr. Quigley may be excused from making demand if a majority of the Board members who made the

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[11] Shoen, 122 Nev. at 636-37, 137 P.3d at 1181.

[12] Under Pennsylvania law, a similar analysis is undertaken with respect to the directors who consider the plaintiff's demand. *See* Cuker, 547 Pa. 600, 692 A.2d 1042.

[13] Shoen, 122 Nev. at 639, 137 P.3d at 1183.

[14] *Id.*

[15] *Id.*, 122 Nev. at 644, 137 P.3d at 1186.

decision were not disinterested and independent.[16] Where the challenged decision was made by others, he may be excused if a majority of the Board members sitting at the time his suit was filed are not disinterested and independent.[17] In the common parlance of Delaware (and Nevada) corporate law, the former fact scenario calls for an Aronson analysis and the latter calls for a Rales review, after the Delaware Supreme Court cases in which such tests were first enunciated.

In deciding whether Mr. Quigley may continue to press his claims against the ProPhase officers and Board members, the question for this court is whether Mr. Quigley may be excused from demanding that the Board itself consider the merits of such claims. For purposes of undertaking this analysis, the court has broken down the four fact situations that plaintiff says were wrongly handled into six separate decisions/acts by ProPhase representatives.

II. The Reinstatement and Termination Of Dr. Richard Rosenbloom.

Dr. Rosenbloom was the head of ProPhase's pharmaceutical division ("Pharma Division") from at least 2001 through October, 2009. During the majority of that time, Mr. Quigley was CEO of ProPhase, and the company apparently invested almost $30 million in the Pharma Division. Dr. Rosenbloom was the inventor and patent holder of the new products that ProPhase, under Mr. Quigley's control, hoped to develop and take to market.

During the proxy contest, Mr. Quigley and Dr. Rosenbloom apparently had a falling out. Based upon evidence purloined by Dr. Rosenbloom's housekeeper, Mr. Quigley accused Dr. Rosenbloom, in a press release, of disloyalty for accepting a personal loan from Mr. Karkus. Mr. Quigley further accused Dr. Rosenbloom, somewhat less publicly, of receiving improper

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[16] *See* Aronson v. Lewis, 473 A.2d 805, 807 (Del. 1984) (cited with approval in Shoen).

[17] *See* Rales v. Blasband, 634 A.2d 927, 933 (Del. 1993), cited with approval in Shoen, 122 Nev. at 638-39, 137 P.3d at 1183 (" [W]hen the board considering a demand is not implicated in a challenged business transaction, the question is whether the board that would be addressing the demand can impartially consider its merits without being influenced by improper considerations, such that it could properly exercise its independent and disinterested business judgment in responding to a demand.")

payments from several ProPhase vendors. Mr. Quigley suspended Dr. Rosenbloom without pay pending further investigation. Shortly thereafter, Mr. Karkus and the other defendants assumed control of ProPhase.

Faced with a threatened defamation and invasion of privacy lawsuit by Dr. Rosenbloom, who was a key, but now suspended, employee of the company that they were suddenly running, the new Board decided to reinstate him.[18] The Board also decided to form a Special Committee, composed of Mssrs. Burnett, Leventhal[19] and DeShazo, to investigate the alleged wrongful payments to him from vendors.[20] The Special Committee was authorized to hire counsel to assist in their investigation, and they hired Herbert Kozlov of Reed Smith.

While the investigation into the alleged improper payments proceeded, the Board also discovered that the product which was furthest through the Pharma Division's development pipeline, upon which Dr. Rosenbloom had been working and the Company was relying for additional revenue, had failed in a FDA mandated study. Mr. Kozlov subsequently issued his Report, in which he recommended

> a negotiated resolution of the Company's relationship with [Dr.] Rosenbloom, which includes a release by him of his [defamation and privacy] claims against the Company and its agents, and, if his ongoing services are considered valuable to the Company's future business prospects, assures that those services remain

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[18] *See* Ex. 10. At that time, the Board was composed of Mssrs. Karkus, DeShazo, Leventhal, McCubbin, Frank, Burnett and Gleckel. At this meeting, "Mr. Karkus reminded the Board, as had been previously disclosed in connection with the second lawsuit, he had previously loaned Dr. Rosenbloom approximately $55,000," which had not yet been repaid.

[19] *See id.* ("Mr. Leventhal disclosed to the Board that several years ago he had entered into a mortgage loan with Dr. Rosenbloom but that mortgage loan had been repaid in full prior to the initiation of the proxy contest or the proxy litigation. . . . .Mr. Leventhal added he was in the regular business of making such loans.")

[20] *See id.* ("Upon motion duly made and seconded a resolution was proposed to form a Special Committee of the Board of Directors, comprised of Mr. Burnett, Mr. Leventhal and Mr. DeShazo, to investigate the allegations with respect to Dr. Rosenbloom's receipt of payments from vendors, and to report its findings and recommendations to the full Board. The Special Committee shall be authorized to engage such counsel and consultants as it deems appropriate, and the Corporation's officers and employees are instructed to cooperate fully with the Special Committee and its representatives in their investigation.")

> available to the Company. The variables available in any negotiated resolution include acquiring his royalty interest [in the patents], reimbursing his docked wages, reimbursing the attorneys fees he incurred, exchanging releases, and payment of a cash settlement amount.[21]

At a special meeting of the Board to consider this Report, the Board[22]

> RESOLVED, that the position currently filled by Dr. Rosenbloom is hereby eliminated and the Chief Operating Officer be, and hereby is, authorized and directed to (a) terminate Dr. Rosenbloom's employment, (b) initiate severance and consulting agreement negotiations with Dr. Rosenbloom, and, subject to approval by the Audit Committee or the Board, enter into a severance agreement and consulting agreement that is mutually acceptable to Dr. Rosenbloom and the Corporation.[23]

Mr. Karkus recused himself from this decision because of his outstanding personal loan to Dr. Rosenbloom.[24]

Subsequently, ProPhase entered into the following agreements with Dr. Rosenbloom: a one year Consulting Agreement, pursuant to which he was paid $14,800 per month and entered into a non-compete with ProPhase; an Assignment and Release Agreement, pursuant to which he assigned his 5% patent royalties to ProPhase and ProPhase paid him $120,000; and a General Release in which he gave up his claims against the company and ProPhase paid him $20,000. ProPhase also released its claims against him.

A. Were the Board Members Disinterested?

Mr. Quigley objects to the Rosenbloom transactions because he believes it was improper for the new Board to reinstate a person whom he views as a disloyal crook, pay that employee

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[21] Ex. 72.

[22] The Board was comprised of Mssrs. DeShazo, Leventhal, Frank, Burnett, McCubbin and Gleckel. *See* Ex. 17.

[23] *Id.*

[24] *See id.* ("Ted Karkus was present for the purposes of establishing a quorum, but then was dismissed from the meeting.")

handsomely to leave four months later, and continue to pay him to do nothing for an additional year. In Mr. Quigley's view, the only motive the Board could have for such aberrant behavior was nefarious – to reward an insider who somehow helped them win their proxy fight against Mr. Quigley.

Mr. Quigley claims that Mr. Karkus was interested in the Rosenbloom transactions due to the outstanding loan he had made to Dr Rosenbloom, and that Mr. Leventhal was similarly interested due to the prior, repaid loan he had made to Dr. Rosenbloom. In an abundance of caution, the court will view Mr. Karkus' unpaid loan as evidence of his interest in the Rosenbloom decisions, but Mr. Leventhal's prior, repaid loan does not create a similar interest on his part. Mr. Leventhal is therefore sufficiently disinterested, and there has been no showing that any of the other directors, Mssrs. DeShazo, Frank, Burnett, McCubbin and Gleckel, had a personal interest in the Rosenbloom transactions. Therefore, Mr. Quigley has not shown that "a majority[25] of the board members would be materially affected, either to their benefit or detriment, by [the Rosenbloom] decision[s] of the board, in a manner not shared by the corporation and the stockholders."[26]

B. Were the Board Members Independent?

Mr. Quigley claims that all the Board members have some relationship with Mr. Karkus which renders them not independent of, *i.e.*, dependent upon, him, so that if he has an interest in a transaction they would necessarily, blindly, do his bidding with respect to it. However, none of the relationships are of that intimate a nature.

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[25] One out of seven is much less than a majority.

[26] Shoen, 122 Nev. at 639, 137 P.3d at 1183.

Mr. Karkus is Mr. Frank's brother-in-law's wife's brother and they have occasionally met socially as a result, but such a relationship can hardly be deemed one involving dependence and control; there is not even a word in English to describe such a familial tie because it is so remote.

Dr. Gleckel is the Karkus family's physician and has been for more than 40 years. He occasionally sees the Karkus family socially. Dr. Gleckel previously served on the board of another company in which Mr. Karkus was an investor.

Mr. McCubbin is employed as a senior officer and director of a company in which Mr. Karkus owns less than 5% of the shares. In such capacities, they have met, spoken and dined together occasionally before Mr. McCubbin became a Board member of ProPhase.

Mr. Burnett sold a house to Mr. Karkus and, since then, has met with him periodically for lunch to discuss investment opportunities.

Mr. Leventhal likewise had a few social encounters with Mr. Karkus before he joined the board of ProPhase.

Mr. DeShazo, who is not named as a defendant in this action presumably because he passed away in 2011, had phone conversations with Mr. Karkus regarding their ownership of ProPhase (formerly Quigley) shares before the proxy fight.

Such casual social and business contacts do not render Mssrs. Burnett, Leventhal, McCubbin, Gleckel or DeShazo in thrall to Mr. Karkus. All are or were experienced businessmen in their own right and absent other evidence showing they are somehow beholden to or influenced by Mr. Karkus, the court will consider them independent.[27]

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[27] Shoen, 122 Nev. at 639, 137 P.3d at 1183 ("[D]irectors' independence can be implicated by particularly alleging that the directors' execution of their duties is unduly influenced, manifesting a direction of corporate conduct in such a way as to comport with the wishes or interests of the person doing the controlling. A lack of independence also can be indicated with facts that show that the majority is beholden to directors who would be liable or for other reasons is unable to consider a demand on its merits, for directors' discretion must be free from the influence of other interested persons.")

Mr. Quigley objects that all the above evidence regarding the director's relationships with Mr. Karkus is based on their own testimony and therefore violates the Nanty-Glo rule.[28] However, he then relies upon the same such evidence himself.[29] More importantly, he does not come forward with additional or contradictory evidence to show that the directors somehow lack independence.[30] Therefore, he has failed in his burden of proof.

C. Did the Board Members Exercise Due Care?

Since Mr. Quigley has not shown that a majority of the directors who approved the Rosenbloom transactions were interested or dependent in some manner, he is placed in the difficult position of having to overcome the presumption that the business judgment rule shields the board from liability for those decisions.[31] In other words, he must offer evidence, not just hindsight and conjecture, to show that the Board did not proceed with the requisite due care.

The heart of Mr. Quigley's argument against the Rosenbloom transactions, and all the other complained of decisions, is that they were not in the best interests of ProPhase because they cost ProPhase substantial sums of money (and he would not have made them if he was still in charge.) However, the presumption of the business judgment rule protects bad decisions and ill-fated ones,[32] not just ones that increase a company's profits or otherwise succeed.[33] So long as

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[28] *See* Borough of Nanty-Glo v. Am. Sur. Co. of New York, 309 Pa. 236, 238, 163 A. 523, 524 (1932) ("The credibility of these witnesses, without whose testimony plaintiff could not have recovered, was for the jury.")

[29] *See* Plaintiff's Memorandum of Law in Opposition to Defendants' Motion to Dismiss ("Plaintiff's Memo"), p. 77 (citing Defendants' Memorandum of Law).

[30] *See* Carringer v. Taylor, 402 Pa. Super. 197, 200, 586 A.2d 928, 929 (1990) (Nanty Glo is not violated where the party with the burden of proof admits certain facts against him and fails to produce other facts in his favor.)

[31] Shoen, 122 Nev. at 636-37, 137 P.3d at 1181 ("Of course, since approval of a transaction by the majority of a disinterested and independent board usually bolsters the presumption that the transaction was carried out with the requisite due care, in such cases, a heavy burden falls on a plaintiff to avoid pre-suit demand.")

the directors exercised due care in making their decision they are insulated from liability even if it turns out badly.

With respect to the decisions to reinstate Dr. Rosenbloom and to let him go with a sizeable severance package four months later, the Board considered several factors: his potential utility to the company as inventor and COO of the Pharma Division; his institutional knowledge; his threats to sue the company for invasion of privacy; the accusations of financial impropriety against him; and the failure of the main product he had been shepherding through the pipeline. All of these are valid business considerations.

The first three considerations informed the Board's decision to reinstate him pending investigation, and the last two, in conjunction with the investigation and report by counsel, weighed heavily in the Board's decision to separate him from the company. The court will not fault the Board for taking a measured approach and seeking facts from a professional before acting. In fact, reliance upon counsel's or another professional's advice is exactly the sort of due care that a Board should undertake in making an important business decision.[34]

Mr. Quigley makes much of the fact that counsel, Mr. Kozlov and Reed Smith, had represented Mr. Karkus previously in the proxy fight and other matters. However, without specific evidence of wrongdoing or conflict, this court is not going to presume that an attorney

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[32] *See* Shoen, 122 Nev. at 636, 137 P.3d at 1181 ("even a bad decision is generally protected by the business judgment rule's presumption that the directors acted in good faith, with knowledge of the pertinent information, and with an honest belief that the action would serve the corporation's interests").

[33] If only good decisions were protected by the business judgment rule, there would be little need for the rule, since such decisions are rarely challenged.

[34] *See* Nev. Rev. Stat. § 78.138 ("In performing their respective duties, directors and officers are entitled to rely on information, opinions, reports, books of account or statements, including financial statements and other financial data, that are prepared or presented by . . . Counsel, public accountants, financial advisers, valuation advisers, investment bankers or other persons as to matters reasonably believed to be within the preparer's or presenter's professional or expert competence.) Pennsylvania has a very similar rule. *See* 15 Pa. Cons. Stat. § 1712.

breached his fiduciary duties to his client, in this case ProPhase and its directors, when he rendered advice to them.

Since Mr. Quigley has not proffered evidence that the disinterested and independent ProPhase directors acted without due care in the Rosenbloom transactions, they are entitled to the protection of the business judgment rule, and Mr. Quigley is not excused from first making demand upon the Board with respect to those transactions. Therefore, Mr. Quigley's claims with respect to the Rosenbloom transactions must be dismissed.

III. The Settlement With Mr. Ligums.

Mr. Quigley objects to the company's decision in October, 2009, to settle with Mr. Ligums, a substantial ProPhase shareholder and a defendant in the proxy contest, who threatened to sue ProPhase for damages he incurred in connection with the Federal Proxy Litigation, which had been filed by Mr. Quigley against him.[35]

The negotiations with Mr. Ligums' attorney and with ProPhase's insurance carrier were undertaken on behalf of ProPhase by Mr. Cuddihy and ProPhase's counsel, Mr. Kozlov. Pursuant to Board resolution, management had authority to bind the company to pay up to $375,000 without board approval.[36] The parties ultimately agreed that ProPhase would pay Mr. Ligums $190,000, ProPhase's insurer would pay an additional $190,000, and Mr. Ligums would release his claims against ProPhase. Because the amount the company was paying was less than $375,000, the Board did not vote on the transaction.[37]

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[35] *See* Ex. 38 (Demand Letters); Exs. 71A and 71B (Complaints in Federal Proxy Litigation.)

[36] *See* Ex. 10.

[37] Mr. Quigley argues that the insurance company's payment should be counted as money paid by or on behalf of the company and therefore the amount committed by management, $380,000, exceeded by $5,000 their express authority. Even if that were true, such an unauthorized act could subsequently be ratified by the Board. *See* McGuire Performance Solutions, Inc. v. Massengill, 904 A.2d 971, 978 (Pa. Super. 2006) ("A corporation may ratify unauthorized acts which are within the scope of its corporate powers.")

Mr. Quigley challenges "the Board's decision to permit management, specifically Mr. Cuddihy - through Reed Smith attorney Kozlov - to unilaterally handle Ligums' demand" and for him to have settled for more than Mr. Ligums' claimed attorneys' fees in the Federal Proxy Litigation.[38] However, the 2009 Board does not appear to have specifically authorized Mssrs. Cuddihy, Koslov and/or Karkus to engage in such negotiations. This does not mean that management's actions are necessarily invalid; it simply means that Mr. Quigley's criticisms of the Ligums settlement must be analyzed under the Rales standard rather than the Aronson one. In other words, where the challenged decision was made by management, Mr. Quigley may be excused from making demand if a majority of the Board members sitting at the time this suit was filed (2011) are not disinterested and independent.[39]

A. Are the Board Members Disinterested and Independent?

Mr. Quigley points out that Mr. Ligums was instrumental in assisting Mr. Karkus in the proxy fight, Mr. Ligums was also at one time a stockbroker for Mr. Leventhal, and he introduced Mr. DeShazo to Mr. Karkus.[40] Even if Mr. Ligums' and Mr. Karkus' relationship is sufficient to make Mr. Karkus not disinterested in the settlement with Mr. Ligums, Mr. Leventhal's and Mr. DeShazo's relationships with Mr. Leventhal are too attenuated to rise to the level of interestedness or dependency. Therefore, a majority of the current board are sufficiently disinterested and independent to vote on the Ligums transaction and Mr. Quigley is not excused from making demand upon them.

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[38] Plaintiff's Memo, pp. 93-94.

[39] Shoen, 122 Nev. at 638-39, 137 P.3d at 1183 ("[W]hen the board considering a demand is not implicated in a challenged business transaction, the question is whether the board that would be addressing the demand can impartially consider its merits without being influenced by improper considerations, such that it could properly exercise its independent and disinterested business judgment in responding to a demand.")

[40] *See* Plaintiff's Memo, p. 94, n. 50. Mr. Quigley does not make such an argument with respect to the remaining directors.

B. Could/Did the Board Members Exercise Due Care With Respect To The Ligums Settlement? [41]

Mr. Quigley makes much of the fact that the Ligums settlement amount ($380,000) significantly exceeded the attorneys' fees ($254,274.24) that Mr. Ligums claimed to have incurred as a result of being sued by Mr. Quigley and the company in the Federal Proxy Litigation. However, Mr. Ligums also claimed that he had been defamed in his profession as a stockbroker by certain proxy related press releases that Mr. Quigley issued on behalf of ProPhase,[42] and those additional alleged damages were never quantified by Mr. Ligums. Furthermore, the settlement amount was negotiated and recommended by counsel for Prophase, as well as ProPhase's insurance company, so it was not unreasonable for management, or the Board members, to rely upon such expertise in approving the settlement amount.[43]

Since Mr. Quigley has failed to produce evidence to show that his demand may be excused with respect to the Ligums settlement, his claims based on that transaction must be dismissed.

IV. Entering Into The Phosphagenics Joint Venture.

Mr. Quigley further complains that, in 2010, the Board authorized Prophase to enter into a joint venture with an Australian company, Phosphagenics, which had developed a proprietary technology called TPM for delivering drugs transdermally. Under the terms of the joint venture, Prophase paid Phosphagenics $1 million plus 1,440,000 shares of ProPhase stock. In addition,

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[41] Under the Rales test, such an analysis is not really necessary, but the court includes it to further illuminate the rationale for its decision.

[42] *See* Exs. 38, 71E.

[43] *See* Nev. Rev. Stat. § 78.138 ("In performing their respective duties, directors and officers are entitled to rely on information, opinions, reports, books of account or statements, including financial statements and other financial data, that are prepared or presented by . . . Counsel, public accountants, financial advisers, valuation advisers, investment bankers or other persons as to matters reasonably believed to be within the preparer's or presenter's professional or expert competence.)

ProPhase agreed to give the joint venture another $500,00 in start-up capital, plus up to $2.5 million for further development of products using TPM. In exchange, Phosphagenics gave the joint venture a royalty free license for its TPM technology and access to its research team.[44]

In connection with the joint venture negotiations, Mr. Kozlov had Mr. Karkus and the CEO of Phosphagenics sign a conflict waiver letter which included the following:

> 1. The Quigley Corporation and Phosphagenics Ltd. are discussing and negotiating a possible license agreement and joint venture arrangement (the "Transaction") which would be implemented pursuant to entering into an LLC Operating Agreement.
> 2. You are aware that Reed Smith has previously represented Phosphagenics and that I have provided legal services to Phosphagenics.
> 3. You are aware that Reed Smith currently represents Quigley in a wide variety of matters; that we are outside general counsel to Quigley; that I currently provide legal services to Quigley.
> 4. You are aware that I enjoy a personal friendship with Harry Rosen, the CEO of Phosphagenics; that I am also a stockholder in Phosphagenics;[45] and that I also enjoy a personal friendship with Ted Karkus, CEO of Quigley.
> 5. You are aware that Reed Smith and I are acting for Quigley in connection with the Transaction. We are not representing Phosphagenics in connection with the Transaction or any other current matters. However, the possibility exists that Phosphagenics will request Reed Smith and/or me to provide legal representation on matters in the future. Among other things, Reed Smith has represented Phosphagenics in connection with filing certain patents which the joint venture would rely upon. [46]

A. Were the Board Members Disinterested and Independent?

The Board members who voted to approve the terms of the joint venture were Mssrs. Karkus, DeShazo, Frank, Burnett, McCubbin, Gleckel and Leventhal.[47] There is no claim that any of them had any interest in Phosphagenics, nor a personal stake in the joint venture. There is also no claim that any of them were not independent of Phosphagenics. As previously discussed,

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[44] *See* Ex. 26.

[45] Mr. Koslov apparently owns over 4 million shares of Phosphagenics' stock.

[46] Ex. 24.

[47] *See* Ex. 26.

the court deems them to have been sufficiently independent of Mr. Karkus, and he does not appear to have had any personal stake in the joint venture either. Therefore, the entire Board, which acted unanimously to approve the terms of the Phosphagenics joint venture, was disinterested and independent for purposes of assessing whether demand should be made under Aronson.

Mr. Quigley repeatedly points out that Mr. Kozlov was a shareholder of Phosphagenics and that his firm had done patent work for Phosphagenics in the past, so that he had an apparent interest in seeing this deal come to fruition. However, Mr. Kozlov was not a member of the Board of ProPhase, so any conflict of interest he may have had cannot be imputed to the Board. Furthermore, he does not appear to have advised the Board regarding the prudence of entering into the joint venture, nor negotiated its basic terms; his firm simply prepared the documents embodying those terms.

With respect to any aspect of the joint venture that was not specifically approved by the Board in 2010, such as the attorney waiver letter, there is no evidence that the 2011 Board members were anything but disinterested and independent as required by Rales. Mr. Burnett did make a $250,000 loan to Mr. Karkus in May 2011, which was not repaid until April 2012, but that does not make Mr. Burnett dependent on Mr. Karkus; rather it appears Mr. Karkus was beholden to Mr. Burnett. Even if one takes both Mr. Karkus and Mr. Burnett out of the equation, a clear majority of the 2011 Board members were sufficiently disinterested and independent enough to review in good faith a demand by Mr. Quigley with respect to the aspects of the joint venture that had not previously been approved by the Board.

B. Did the Board Members Exercise Due Care In Approving the Joint Venture?

The Phosphagenics joint venture appears to have been undertaken in an attempt to diversify ProPhase's product line and ultimately to increase profits, both of which are normally considered laudatory corporate goals on which management and the Board should be focused. Indeed, prior management under Mr. Quigley apparently had similar goals in mind when he formed ProPhase's Pharma Division and hired Dr. Rosenbloom to run it and bring newly discovered products to market.

Management, in the form of Mr. Petterutti,[48] ProPhase's Vice President of Technology and Product Development, researched Phosphagenics and the technology behind its product, as well as competing transdermal products. This research was presented to the Board beginning in the Fall of 2009[49] and continuing through the Spring of 2010.[50] In addition, Board members conducted their own research, and Mr. Cuddihy, the CFO, analyzed what ProPhase could afford to contribute to the transaction.[51] Management also retained an outside expert to render an opinion regarding the viability of the TPM technology; the report was favorable and was presented to the Board for review.[52] Counsel at Reed Smith, other than Mr. Koslov, drafted the agreements with Phosphagenics on behalf of Prophase and attended Board meetings where the

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[48] Mr. Petterutti worked for ProPhase under Dr. Rosenbloom and Mr. Quigley and quit before this action commenced, so he can hardly be viewed as one of Mr. Karkus' pawns.

[49] Other options were apparently presented as well.

[50] *See* Exs. 21, 23, 25, 26, 48.

[51] *See* Ex. 25.

[52] *See id.*

directors discussed the deal.[53] In other words, the Board engaged in proper due diligence before approving the Phosphagenics joint venture.

Mr. Quigley makes much of Phosphagenics' declining revenues and poor financials.[54] However, the Board of ProPhase was not considering the acquisition of Phosphagenics itself; they considered and approved a mechanism by which ProPhase gained access to Phosphagenics' technology, which they reasonably believed did have value if properly exploited. The Board members could always have spent more time and money investigating this deal before consenting to it, as Mr. Quigley points out. However, they were sufficiently informed in this instance to be able to claim the protections of the business judgment rule.

V. The Repurchase of ProPhase Stock From Phosphagenics.

The joint venture apparently did not proceed with product development quickly enough for Phosphagenics, so in 2011, Phosphagenics asked that the 1,444,000 restricted ProPhase shares it held be repurchased. In August 2011, after the CFO Mr. Cuddihy determined that ProPhase could not afford to repurchase all the stock, the Board authorized the company to repurchase almost half the shares.[55] Mr. Karkus arranged to have Mr. DeShazo,[56] Mr. Ligums and related persons and entities purchase the remaining shares held by Phosphagenics. Mr. Quigley apparently wanted to purchase those shares himself, but Phosphagenics was restricted from selling it to third parties without ProPhase's consent.

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[53] *See* Ex. 25.

[54] *See* Plaintiff's Memo, pp. 29-30.

[55] *See* Ex. 31.

[56] Mr. DeShazo had previously resigned from the Board.

A. Were the Board Members Disinterested and Independent?

The Board members who voted to approve the buy-back of the stock were Mssrs. Karkus, Frank, Burnett, McCubbin, Gleckel and Leventhal.[57] Mr. Quigley does not claim that any of them profited from the buy-back, and as shown before, they were otherwise disinterested and independent of both Mr. Karkus and Phosphagenics. The persons who did profit from the buy-back, Mssrs. DeShazo and Ligums, were not Board members.

B. Did the Board Members Exercise Due Care?

In approving the buy-back of only 690,000 of the shares owned by Phosphagenics and allowing the sale of the remainder to other ProPhase shareholders, the Board members reasonably relied upon the advice of Mr. Cuddihy, ProPhase's CFO, as to the amount the company could afford to repurchase.[58]

Mr. Quigley makes much of the fact that Mr. Karkus and the rest of the Board permitted shareholders who supported their (rather than his) agenda to purchase the remaining shares at a discount from market price. However, he does not show how this was damaging to ProPhase, rather than to him personally. If ProPhase had repurchased all of the stock, it could have benefitted from increases in the market value of the stock (or been harmed by decreases in its market value), but the directors, upon the advice of the CFO, decided that it was unwise to spend that much of the company's cash. Such informed business decisions by disinterested and independent directors are exactly what the business judgment rule is intended to protect.

While the Board's decisions with respect to the Phosphagenics' transaction may have been risky or unwise in retrospect, Mr. Quigley has not proffered evidence that either of the

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[57] *See* Ex. 31.

[58] *See id.*

Board's decisions were made improperly. Therefore, his claims based on the Phosphagenics transactions must be dismissed.

VI. The Board Decisions Regarding Mr. Karkus' Compensation.

Mr. Quigley complains that Mr. Karkus was grossly overpaid by ProPhase. Mr. Karkus' base salary, which was approved by the Board each year, was: $369,315 in the second half of 2009; $750.000 in 2010; $703,313 in 2011; and $675,000 in 2012.[59] It should be noted that Mr. Quigley's base salary as CEO was greater: $838,000 in 2006; $905,000 in 2007; $977,000 in 2008; and $446,154 for the first half of 2009.[60] Even including the other compensation awarded to Mr. Karkus, which will be discussed below, Mr. Karkus' earnings are comparable to, and in fact less than, Mr. Quigley's were, so they do not fly in face of the company's history.

In addition to his base salary, once the Board and the shareholders enacted the 2010 Equity Compensation Plan,[61] Mssrs. Karkus and Cuddihy were awarded additional performance incentives in the form of stock options. At the end of 2010, the Compensation Committee recommended and the Board approved awarding 600,000 in stock options to Mr. Karkus, 100,000 of which vested each year for six years.[62] Even though they could not be exercised until future years, for accounting purposes they had to be valued at the time of grant and were so

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[59] *See* Exs. C27, C30, and C32 (ProPhase's Annual Proxy Statements for 2011, 2012, and 2013.)

[60] *See* Exs. C17, C19, C22, and C25 (The Quigley Corp.'s Annual Proxy Statements for 2007, 2008, 2009 and 2010).

[61] *See* Exs. 49, 50.

[62] *See* Ex. 50.

valued at $399,799.[63] In addition, the board awarded Mr. Cuddihy 200,000 stock options vesting over a 4 year period which were valued at $124,378.[64]

A. **Were the Board Members Disinterested and Independent?**

As set forth in detail above, all the Board members were sufficiently independent of Mr. Karkus and disinterested throughout the 2009 – 2010 period during which the Board members made these compensation decisions.

B. **Did the Board Members Exercise Due Care?**

Setting executive compensation is the Board's prerogative and courts will usually defer to the Board's decision on such matters.[65] In this case, the Board took steps to try to determine what an appropriate salary would be, including hiring a consultant to opine as to the amount Mr. Karkus should be paid, and they took that report into account when they voted on his initial salary:

> As the next order of business the Independent Directors discussed engaging Mr. Karkus on a fulltime basis as CEO of the Corporation, it being noted that he was currently serving as interim CEO of the Corporation. . . . Mr. DeShazo reported, and asked that the minutes reflect the fact that the Compensation Committee has recommend to the Board that the Board accept the recommendation of Buck Consultants with respect to the compensation package to be offered to Mr. Karkus. Accordingly, upon motion duly made and seconded, and unanimously carried, with Mr. Karkus abstaining, the Board resolved to offer Mr. Karkus the position as Chief Executive officer of The Quigley Corporation, at a base salary of $750,000 per annum, together with such other benefits and perquisites as are customarily offered to senior executives at the Corporation, including but not limited to a monthly automobile and local transportation allowance of $1,200 per month.[66]

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[63] *See* Ex. C30

[64] *See* Ex. 50; Ex. C30.

[65] *See* Brehm v. Eisner, 746 A.2d 244, 263 (Del. 2000) ("[A] board's decision on executive compensation is entitled to great deference. It is the essence of business judgment for a board to determine if a particular individual warrants large amounts of money, whether in the form of current salary or severance provisions.")

[66] Ex. 11.

Although the Buck Report does say that $750,000 is high for a CEO of a company of ProPhase's size, it found such an amount to be a reasonable salary, particularly in the absence of other forms of compensation.[67] The Board thereby made its salary decision properly.

Stock and stock options are common forms of executive compensation and are meant to encourage the executives who receive them to increase the value of the company, or at least of the company's stock, which inures to the benefit of all shareholders, including, in this case, Mr. Quigley. Such stock awards may also serve to make Mr. Quigley's enemies more entrenched in the management of what he considers to be his company, but that is the way corporate democracy often works.

VII. Compensation Committee Decisions Regarding Compensation.

In March 2010, the Compensation Committee awarded an annual bonus of $87,500 to Mr. Karkus and $27,500 to Mr. Cuddihy based on ProPhase's 2009 financials and an Equilar Report regarding comparable executive compensation.[68] In March 2011, the Compensation Committee awarded a bonus of $150,000 to Mr. Karkus and $75,000 to Mr. Cuddihy based on their accomplishments during 2010.[69] After Board and shareholder approval of an amendment to the 2010 Equity Compensation Plan, the Compensation Committee opted to award these 2010 bonuses in the form of stock rather than cash.[70] They also opted to pay $150,000 of Mr. Karkus' $750,000 salary and his $144,000 in deferred compensation in the form of stock.[71]

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[67] Ex. 41. The other forms of compensation came later, and his base salary was adjusted downwards as a result.

[68] *See* Ex. 44.

[69] *See* Ex. 63.

[70] *See* Ex. 53.

[71] *See id.*

In November, 2011, the Compensation Committee approved a decrease of Mr. Karkus' base salary to $675,000 and an increase of Mr. Cuddihy's to $350,000.[72] In December, 2011, the Compensation Committee chose to award Mr. Karkus a bonus of $150,000 payable in stock and Mr. Cuddihy a bonus of $75,000 to be paid half in stock and half in cash, based on their respective performances during 2011 and peer group studies.[73] In December, 2012, the Compensation Committee awarded Mr. Karkus a bonus of $225,000 and Mr. Cuddihy a bonus of $100,000 based on their accomplishments, and the company's financial performance, in 2012.[74]

A. Were/Are the Board Members Disinterested and Independent?

The 2009 Compensation Committee was composed of Mssrs. DeShazo, Leventhal and Burnett.[75] In August, 2010, the Compensation Committee changed to Mssrs. Frank, Leventhal, and Burnett,[76] and in the middle of 2012, the Compensation Committee came to be comprised of Mssrs. Gleckel, Leventhal and Burnett.[77] Even if Mr. Burnett's $250,000 loan to Mr. Karkus, which was made in May, 2011, and repaid in April 2012, caused him to be too "interested" in Mr. Karkus' finances, the majority of the Compensation Committee was always disinterested and independent.

More importantly, the majority of the 2011 and 2012 Boards that would consider any demand by Mr. Quigley based on these decisions by the Compensation Committee were/are

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[72] *See* Ex. 101. This compensation decision, like the bonus awards, does not appear to have been approved by the full Board at the time it was made, so it is subject to the Rales analysis, not the Aronson test.

[73] *See* Ex. 102.

[74] *See* Ex. 60.

[75] *See* Ex. 61.

[76] *See* Ex. 99.

[77] *See* Ex. 60.

sufficiently disinterested and independent that Mr. Quigley's failure to make demand upon them cannot be excused.

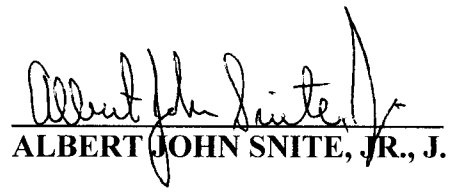
B. Could/Did The Board Members Exercise Due Care In Approving Such Compensation?

In reaching these compensation decisions, the members of the Compensation Committee considered reasonable criteria such as the officers' yearly accomplishments, the financial health of ProPhase, and the compensation of similarly situated executives. Absent a gross abuse of discretion, of which no evidence has been presented, this court will not substitute its (or Mr. Quigley's) judgment for that of the independent and disinterested directors who made such compensation decisions. Therefore, Mr. Quigley cannot be excused from making demand upon the Board with respect to his claims based on Mr. Karkus' compensation, and all such claims must be dismissed.

CONCLUSION

For all of the foregoing reasons, defendants' Motion to Dismiss is granted and Mr. Quigley's claims for breach of fiduciary duty, conspiracy and waste of corporate assets are dismissed. In light of the discovery undertaken in this action, Mr. Quigley's claim to inspect corporate records is dismissed as moot, as is defendants' claim that Mr. Quigley is not an appropriate representative plaintiff.

BY THE COURT:



ALBERT JOHN SNITE, JR., J.