KING PHARMACEUTICALS INC
Form 10-Q
November 09, 2006

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

Form 10-Q

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2006

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from to

Commission File No. 001-15875

King Pharmaceuticals, Inc.
(Exact name of registrant as specified in its charter)

Tennessee	**54-1684963**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
501 Fifth Street, Bristol, TN	**37620**
(Address of principal executive offices)	*(Zip Code)*

(423) 989-8000
(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer þ Accelerated filer o Non-accelerated filer o

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

Number of shares outstanding of Registrant s common stock as of November 7, 2006: 243,116,337

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PART I FINANCIAL INFORMATION

Item 1. *Financial Statements*

KING PHARMACEUTICALS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands)

	September 30, 2006 (Unaudited)	December 31, 2005
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 138,054	$ 30,014
Investments in debt securities	779,545	494,663
Restricted cash		130,400
Accounts receivable, net of allowance for doubtful accounts of $5,602 and $12,280, respectively	255,746	223,581
Inventories	186,770	228,063
Deferred income tax assets	69,153	81,777
Prepaid expenses and other current assets	102,356	59,291
Total current assets	1,531,624	1,247,789
Property, plant and equipment, net	303,822	302,474
Intangible assets, net	924,828	967,194
Goodwill	121,152	121,152
Marketable securities	13,508	18,502
Deferred income tax assets	258,498	231,032
Other assets (includes restricted cash of $15,807 and $14,129, respectively)	94,112	77,099
Total assets	$ 3,247,544	$ 2,965,242
LIABILITIES AND SHAREHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	$ 80,810	$ 84,539
Accrued expenses	471,695	519,620
Income taxes payable	20,617	22,301
Current portion of long-term debt	4,257	345,000
Total current liabilities	577,379	971,460
Long-term debt	400,000	

Other liabilities	23,894	20,360
Total liabilities	1,001,273	991,820
Commitments and contingencies (Note 9)		
Shareholders equity	2,246,271	1,973,422
Total liabilities and shareholders equity	$ 3,247,544	$ 2,965,242

See accompanying notes.

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KING PHARMACEUTICALS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(In thousands, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Revenues:				
Net sales	$ 472,570	$ 495,688	$ 1,415,729	$ 1,289,619
Royalty revenue	19,136	22,344	59,857	59,977
Total revenues	491,706	518,032	1,475,586	1,349,596
Operating costs and expenses:				
Cost of revenues, exclusive of depreciation, amortization and impairments shown below	106,473	92,257	305,925	255,677
Selling, general and administrative, exclusive of co-promotion fees and Mylan transaction costs	107,300	111,638	319,480	305,911
Mylan transaction costs		466		3,898
Co-promotion fees	50,294	70,346	162,615	162,588
Total selling, general and administrative expense	157,594	182,450	482,095	472,397
Research and development	38,419	24,049	102,931	53,021
Research and development-in process upon acquisition	25,000		110,000	
Total research and development	63,419	24,049	212,931	53,021
Depreciation and amortization (Note 13)	37,833	31,352	110,745	112,698
Intangible asset impairment			279	126,923
Restructuring charges (Note 13)	3,202	597	3,194	2,603
Gain on sale of products		(20)		(1,458)
Total operating costs and expenses	368,521	330,685	1,115,169	1,021,861
Operating income	123,185	187,347	360,417	327,735
Other income (expense):				
Interest income	8,489	5,253	22,842	11,463
Interest expense	(1,894)	(3,136)	(7,925)	(8,876)
Gain (loss) on investment		1,040		(6,182)
(Loss) gain on early extinguishment of debt	(11)		698	
Other, net	101	(751)	(613)	(2,047)

Total other income (expense)	6,685	2,406	15,002	(5,642)
Income from continuing operations before income taxes	129,870	189,753	375,419	322,093
Income tax expense	40,020	67,109	123,931	111,302
Income from continuing operations	89,850	122,644	251,488	210,791
Discontinued operations (Note 17):				
Income (loss) from discontinued operations	865	(1,226)	775	2,607
Income tax expense (benefit)	310	(439)	278	989
Total income (loss) from discontinued operations, net	555	(787)	497	1,618
Net income	$ 90,405	$ 121,857	$ 251,985	$ 212,409
Income per common share:				
Basic:				
Income from continuing operations	$ 0.37	$ 0.50	$ 1.04	$ 0.87
Total income (loss) from discontinued operations				0.01
Net income	$ 0.37	$ 0.50	$ 1.04	$ 0.88
Diluted:				
Income from continuing operations	$ 0.37	$ 0.50	$ 1.04	$ 0.87
Total income (loss) from discontinued operations				0.01
Net income	$ 0.37	$ 0.50	$ 1.04	$ 0.88

See accompanying notes.

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KING PHARMACEUTICALS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY AND OTHER COMPREHENSIVE INCOME
(Unaudited)
(In thousands, except share data)

	Common Stock		Unearned	Retained	Accumulated Other Comprehensive Income	
	Shares	Amount	Compensation	Earnings	(Loss)	Total
Balance at December 31, 2004	241,706,583	$ 1,210,647	$	$ 637,120	$ 1,023	$ 1,848,790
Comprehensive income:						
Net Income				212,409		212,409
Net unrealized gain on marketable securities, net of tax of $10					75	75
Foreign currency translation					(79)	(79)
Total comprehensive income						212,405
Stock option activity	79,399	682				682
Balance at September 30, 2005	241,785,982	$ 1,211,329	$	$ 849,529	$ 1,019	$ 2,061,877
Balance at December 31, 2005	242,493,416	$ 1,222,246	$ (8,764)	$ 754,953	$ 4,987	$ 1,973,422
Adoption of Statement of Financial Accounting Standard 123(R)		(8,764)	8,764			
Comprehensive income:						
Net income				251,985		251,985
Net unrealized loss on marketable securities, net of tax of $1,978					(3,872)	(3,872)
Foreign currency translation					(317)	(317)
Total comprehensive income						247,796
Stock-based compensation expense		18,774				18,774
Exercise of stock options	421,245	6,279				6,279

Issuance of restricted stock awards	199,005					
Balance at September 30, 2006	243,113,666	$ 1,238,535	$	$ 1,006,938	$ 798	$ 2,246,271

See accompanying notes.

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KING PHARMACEUTICALS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Nine Months Ended September 30,	
	2006	**2005**
Cash flows provided by operating activities	$ 297,257	$ 404,823
Cash flows from investing activities:		
Transfers from (to) restricted cash	128,722	(73,544)
Purchases of investments in debt securities	(1,170,272)	(879,379)
Proceeds from maturities and sales of investments in debt securities	885,390	470,872
Purchases of property, plant and equipment	(31,220)	(32,334)
Proceeds from sale of property and equipment		1
Proceeds from sale of marketable securities		6,453
Palatin collaboration		(10,000)
Purchases of product rights	(24,886)	
Arrow International Limited collaboration	(35,000)	
Net cash used in investing activities	(247,266)	(517,931)
Cash flows from financing activities:		
Proceeds from exercise of stock options, net	6,844	682
Excess tax benefits from stock-based compensation	425	
Proceeds from issuance of long-term debt	400,000	
Payments on long-term debt	(338,434)	
Debt issuance costs	(10,786)	
Net cash provided by financing activities	58,049	682
Increase (decrease) in cash and cash equivalents	108,040	(112,426)
Cash and cash equivalents, beginning of period	30,014	192,656
Cash and cash equivalents, end of period	$ 138,054	$ 80,230

See accompanying notes.

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KING PHARMACEUTICALS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2006 and 2005
(In thousands, except share and per share data)
(Unaudited)

1. General

The accompanying unaudited interim condensed consolidated financial statements of King Pharmaceuticals, Inc. (King or the Company) were prepared by the Company in accordance with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X and, accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of items of a normal recurring nature) considered necessary for a fair presentation are included. Operating results for the three and nine months ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. These consolidated statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2005. The year-end condensed balance sheet was derived from the audited consolidated financial statements but does not include all disclosures required by generally accepted accounting principles.

These consolidated financial statements include the accounts of King and all of its wholly-owned subsidiaries. All intercompany transactions and balances have been eliminated in consolidation.

2. Stock-Based Compensation

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 123(R), Share-Based Payment, which requires the recognition of the fair value of stock-based compensation in net earnings. The Company adopted SFAS No. 123(R) using the modified prospective application transition method and therefore the Company s prior period condensed consolidated financial statements have not been restated and do not reflect the recognition of stock-based compensation costs. For the three and nine months ended September 30, 2006, the Company incurred $5,472 and $15,186 of compensation costs and $1,708 and $4,709 of income tax benefits related to the Company s stock-based compensation arrangements, which together reduced both basic and diluted income per common share by $0.02 and $0.04, respectively. Prior to the Company s adoption of SFAS No. 123(R), it accounted for stock options under the disclosure-only provision of SFAS No. 123, Accounting for Stock Based Compensation, as amended by SFAS No. 148. Under the disclosure-only provision of SFAS No. 123, no compensation cost was recognized for stock options granted prior to January 1, 2006. SFAS No. 123(R) applies to options granted or modified on or after January 1, 2006. Additionally, compensation costs for options that were unvested as of January 1, 2006 must be recognized over their remaining service period.

Prior to the Company s adoption of SFAS No. 123(R), benefits of tax deductions in excess of recognized compensation costs were reported as operating cash flows. SFAS No. 123(R) requires excess tax benefits be reported as a financing cash inflow rather than as a reduction of taxes paid. For the nine months ended September 30, 2006, tax benefits in excess of recognized compensation costs associated with stock option exercises were $425 and are reflected as cash inflows from financing activities.

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KING PHARMACEUTICALS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the three and nine months ended September 30, 2005, had compensation costs for the Company s stock compensation plans been recognized for options granted, consistent with SFAS No. 123, the Company s net income, basic income per common share and diluted income per common share would include adjustments for the following pro forma amounts:

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Net income:		
As reported	$ 121,857	$ 212,409
Less: pro forma compensation costs for options granted	(1,025)	(3,892)
Pro forma	$ 120,832	$ 208,517
Basic income per share:		
As reported	$ 0.50	$ 0.88
Pro forma	$ 0.50	$ 0.86
Diluted income per share:		
As reported	$ 0.50	$ 0.88
Pro forma	$ 0.50	$ 0.86

The fair value of each option grant was estimated on the date of grant using the Black-Scholes option pricing model.

Restricted Stock Awards, Restricted Stock Units and Long-Term Performance Unit Awards

Under its Incentive Plan the Company has granted Restricted Stock Awards (RSAs) and Long-Term Performance Unit Awards (LPUs) to certain employees and has granted Restricted Stock Units (RSUs) to its non-employee directors.

RSAs are grants of shares of common stock restricted from sale or transfer for a period of time, generally three years from grant, but may be restricted over other designated periods as determined by the Company s Board of Directors or a committee of the Board.

RSUs represent the right to receive a share of common stock at the expiration of a restriction period, generally three years from grant, but may be restricted over other designated periods as determined by the Company s Board of Directors or a committee of the Board. The RSUs granted to non-employee directors under the current Compensation Policy for Non-Employee Directors have a restriction period that generally ends one year after grant.

The fair value of RSAs and RSUs is based upon the market price of the underlying common stock as of the date of grant. Compensation expense is recognized on a straight-line basis, including an estimate for forfeitures, over the vesting period.

LPUs are rights to receive common stock of the Company in which the number of shares ultimately received depends on the Company s performance over time. The Company has granted LPUs with two different performance criteria. LPUs were granted with a one-year performance cycle, followed by a two-year restriction period, at the end of which shares of common stock will be earned based on 2006 operating targets. LPUs were also granted based on a three-year performance cycle, at the end of which shares of common stock will be earned based on market-related performance targets over the years 2006 through 2008. At the end of the applicable performance period, the number of shares of common stock awarded is determined by adjusting

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KING PHARMACEUTICALS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

upward or downward from the performance target in a range between 0% and 200%. The final performance percentage on which the number of shares of common stock issued is based, considering performance metrics established for the performance period, will be determined by the Company s Board of Directors or a committee of the Board at its sole discretion.

The fair value of LPUs with a one-year performance cycle is based upon the market price of the underlying common stock as of the date of grant. At each reporting period, compensation expense is recognized based on the most probable performance outcome, including an estimate for forfeitures, on a straight-line basis over the vesting period. Total compensation expense for each award is based on the actual number of shares of common stock that vest multiplied by market price of the common stock as of the date of grant.

The fair value of LPUs with a three-year performance cycle is based on long-term market-based performance targets using a Monte Carlo simulation model which considers the likelihood of all possible outcomes and determines the number of shares expected to vest under each simulation and the expected stock price at that level. The fair value on grant date of the LPU is recognized over the required service period and will not change regardless of the Company s actual performance versus the long-term market-based performance targets.

The following activity has occurred under the Company s existing plans:

	Shares	Weighted Average Grant-Date Fair Value
Restricted Stock Awards:		
Nonvested balance at December 31, 2005	687,775	$ 15.55
Granted	229,155	18.95
Vested	(40,133)	15.60
Forfeited	(30,150)	16.25
Nonvested balance at September 30, 2006	846,647	$ 16.45
Restricted Stock Units:		
Nonvested balance at December 31, 2005		$
Granted	40,250	17.39
Vested		
Forfeited	(5,750)	17.39
Nonvested balance at September 30, 2006	34,500	$ 17.39
Long-Term Performance Unit Awards (one year performance cycle):		
Nonvested balance at December 31, 2005		$
Granted	1,006,251	19.68

Vested	(2,410)		19.68
Forfeited	(20,185)		19.68
Nonvested balance at September 30, 2006	983,656	$	19.68

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KING PHARMACEUTICALS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Shares	Weighted Average Grant-Date Fair Value
Long-Term Performance Unit Awards (three year performance cycle):		
Nonvested balance at December 31, 2005		$
Granted	126,580	29.93
Vested	(467)	29.93
Forfeited	(3,833)	29.93
Nonvested balance at September 30, 2006	122,280	$ 29.93

As of September 30, 2006, there was $9,307 of total unrecognized compensation costs related to RSAs which the Company expects to recognize over a weighted average period of 1.86 years. The expense recognized over the service period includes an estimate of awards that will be forfeited. Previously, the Company recorded the effect of forfeitures as they occurred. The cumulative effect of changing from recording forfeitures related to restricted stock awards as they occurred to estimating forfeitures during the service period was immaterial. As of September 30, 2006, there was $345 of total unrecognized compensation costs related to RSUs which the Company expects to recognize over a weighted average period of 0.58 years. As of September 30, 2006, there was $18,138 of total unrecognized compensation costs related to LPUs which the Company expects to recognize over a weighted average period of 2.26 years. As of September 30, 2005, there were no outstanding RSAs, RSUs or LPUs.

Stock Options

The Company has granted nonqualified and incentive stock options to its officers, employees and directors under its stock option plans. In connection with the plans, options to purchase common stock of the Company are granted at option prices not less than the fair market value of the common stock at the date of grant and either vest immediately or ratably over a designated period, generally one-third on each of the first three anniversaries of the grant date. Compensation expense is recognized on a straight-line basis, including an estimate for forfeitures, over the vesting period.

The fair value of each option award is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions used for grants in the three and nine months ended September 30 (the Company did not issue any options in the third quarter of 2006):

	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005

Expected volatility	46.4%	52.4%	46.2%
Expected term (in years)	4	6	4
Risk-free interest rate	3.96%	4.64%	3.89%
Expected dividend yield	0.00%	0.00%	0.00%

For the three and nine months ended September 30, 2006, the Company utilized the short-cut method to estimate the expected term for stock options granted. Stock options granted prior to 2004 did not have similar vesting characteristics as those granted in the most recent periods and generally vested at the date of grant. The stock options granted after January 1, 2004 generally vest in thirds on each of the first three anniversaries of the grant date. As a result, the data required to estimate the post-vesting exercise behavior was not sufficient to calculate a historical estimate. The short-cut method allows the Company to estimate the expected term using the average of the contractual term and the vesting period. The expected volatility is

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KING PHARMACEUTICALS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

determined based on the historical volatility of King common stock over the expected term. The risk-free rate is based on the U.S. Treasury rate for the expected term at the date of grant.

A summary of option activity under the plans for the nine months ended September 30, 2006 is as follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Outstanding options, December 31, 2005,	7,073,966	$ 18.83	7.65	$ 8,106
Granted	362,965	19.27		
Exercised	(424,260)	16.15		
Expired	(363,602)	24.58		
Forfeited	(144,251)	16.24		
Outstanding options, September 30, 2006	6,504,818	$ 18.77	7.18	$ 8,327
Exercisable, September 30, 2006	4,212,764	$ 20.07	6.43	$ 5,684
Expected to vest, September 30, 2006	2,115,566	$ 16.37	8.58	$ 2,440

As of September 30, 2006, there was $10,645 of total unrecognized compensation costs related to stock options. These costs are expected to be recognized over a weighted average period of 0.95 years.

Cash received from stock option exercises for the nine months ended September 30, 2006 was $6,844. The income tax benefits from stock option exercises totaled $399 for the nine months ended September 30, 2006.

During the nine months ended September 30, the following activity occurred under the Company s plans which cover stock options, RSAs and LPUs:

	2006	2005
Total intrinsic value of stock options exercised	$ 940	$ 244
Total fair value of stock awards vested	$ 647	$
Total fair value of LPUs vested	$ 47	$

As of September 30, 2006, an aggregate of 33,065,280 shares were available for future grant under the Company s stock plans. Awards that expire or are cancelled without delivery of shares generally become available for issuance under the King Pharmaceuticals, Inc. Incentive Plan.

Review of Historical Equity-Based Compensation Grants

In light of widespread coverage in the media and elsewhere concerning the backdating of stock options and similar issues at other public companies, the Audit Committee of the Company s Board of Directors conducted a voluntary review of the Company s practices with respect to granting equity-based compensation. The Audit Committee s review was conducted with the assistance of outside counsel and has been completed. The Audit Committee concluded that there was no fraud or manipulation of financial results with the intent to mislead investors, however, the review uncovered immaterial errors associated with option grants. Management concurs with these conclusions.

The Audit Committee found that for a grant of options made to substantially all Company employees other than the Chief Executive Officer during the fourth quarter of 2000, the Company used an incorrect measurement date in preparing its financial statements. The Company has determined that it will account for this grant by recognizing $3,082 in non-cash compensation expense based on the difference in share price between the grant date and the correct measurement date, which was twelve days later.

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KING PHARMACEUTICALS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Audit Committee also found that in late 2000 and early 2001 four newly hired employees received grants of options on favorable dates within a brief window around their respective dates of hire. These grants were made twenty-seven, eleven, seven and three days from the employee s date of hire, respectively. The Company will account for these grants by treating each employee s date of hire as the measurement date for the grant and recognizing non-cash compensation expense based on the difference in share price between the two dates. The Company will recognize non-cash compensation expense associated with these grants in the following amounts: (i) $148 for a grant to former Vice Chairman Richard Williams; (ii) $221 for a grant to former Chief Financial Officer James Lattanzi; (iii) $3 for a grant to current Corporate Compliance Officer Frederick Brouillette; and (iv) $18 for a grant to a current employee who has never served as an executive officer or director of the Company. With the exception of the options granted to Mr. Williams, none of these options have been exercised.

The Audit Committee also identified procedural flaws in numerous additional grants of options to Company personnel. The Company will recognize in the aggregate $116 in non-cash compensation expense for these grants.

Based on the Audit Committee s findings, the Company will recognize aggregate non-cash compensation expense of $3,588 in the third quarter of 2006 to correct immaterial understatements of compensation expense of: $3,166 in 2000, $304 in 2001, $111 in 2002, $1 in 2003, $2 in 2005 and $4 in the first two quarters of 2006. The cumulative charge is being reported in the current period because the amount of the stock option compensation expense attributable to the prior periods was not material to any previously reported historical period, is not material to the three- or nine-month period ended September 30, 2006 and is not expected to be material to the current fiscal year.

The Company is in the process of further enhancing its procedures and controls relating to the granting of equity-based compensation.

3. Earnings Per Share

The basic and diluted income per common share was determined using the following share data:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Basic income per common share:				
Weighted average common shares	242,256,408	241,754,708	242,162,602	241,736,842
Diluted income per common share:				
Weighted average common shares	242,256,408	241,754,708	242,162,602	241,736,842
Effect of stock options	279,433	151,994	313,234	94,101
Effect of dilutive share awards	261,789		235,379	
Weighted average common shares	242,797,630	241,906,702	242,711,215	241,830,943

For the three months ended September 30, 2006, the weighted average shares that were anti-dilutive, and therefore excluded from the calculation of diluted income per share included options to purchase 5,694,787 shares of common stock and 1,111,690 LPUs. For the nine months ended September 30, 2006, the weighted average shares that were anti-dilutive, and therefore excluded from the calculation of diluted income per share included options to purchase 5,317,551 shares of common stock, 2,341 RSAs and 708,255 LPUs. As of September 30, 2006, the 23/4% Convertible Debentures due November 15, 2021 could also convert into 84,868 shares of common stock in the future, subject to certain contingencies outlined in the indenture. Because the convertible debentures are anti-dilutive, they were not included in the calculation of diluted income per common share. The 11/4% Convertible Senior Notes due April 1, 2026 could be converted into common stock in the future, subject to certain contingencies (See Note 8). These notes are anti-dilutive

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KING PHARMACEUTICALS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

because the conversion price of the notes was greater than the average market price of King Pharmaceuticals, Inc. common stock during the quarter, and therefore are excluded from the calculation of diluted income per common share.

For the three months ended September 30, 2005, the weighted average shares that were anti-dilutive and therefore excluded from the calculation of diluted income per share included options to purchase 5,014,053 shares of common stock. For the nine months ended September 30, 2005, the weighted average shares that were anti-dilutive and therefore excluded from the calculation of diluted income per share included options to purchase 5,493,952 shares of common stock. As of September 30, 2005, the 23/4% Convertible Debentures due November 15, 2021 could also convert into 6,877,990 shares of common stock in the future, subject to certain contingencies outlined in the indenture (See Note 8). Because the convertible debentures are anti-dilutive, they were not included in the calculation of diluted income per common share.

4. Inventories

Inventories consist of the following:

	September 30, 2006	December 31, 2005
Raw materials	$ 110,123	$ 150,979
Work-in-process	21,390	14,955
Finished goods (including $7,668 and $6,728 of sample inventory, respectively)	71,862	91,695
	203,375	257,629
Inventory valuation allowance	(16,605)	(29,566)
Total inventories	$ 186,770	$ 228,063

During the third quarter of 2006, the Company discontinued the Lorabid® product. At the time of the discontinuation of the product, the Company donated inventory of approximately $10,700 which had been previously fully reserved. The discontinuation and donation of the product reduced the Company s finished goods inventory and the inventory valuation allowance during the third quarter of 2006 and had no impact on the accompanying statement of operations.

5. Property, Plant and Equipment

The Company s Rochester, Michigan facility manufactures products for the Company and various third parties. As of September 30, 2006, the net carrying value of the property, plant and equipment at the Rochester facility, excluding the net carrying value associated with the production of Bicillin®, was $62,991. Overall production volume at this facility declined in recent years. The Company currently is transferring to this facility the manufacture of certain products that are currently manufactured by the Company at other Company facilities or for the Company by third

parties. These transfers should increase production and cash flow at the Rochester facility. Management currently believes that the long-term assets associated with the Rochester facility are not impaired based on estimated undiscounted future cash flows. However, if production volumes decline further or if the Company is not successful in transferring additional production to the Rochester facility, the Company may have to write off a portion of the property, plant and equipment associated with this facility.

The net book value of some of the Company s manufacturing facilities currently exceeds fair market value. Management currently believes that the long-term assets associated with these facilities are not impaired based on estimated undiscounted future cash flows. However, if the Company were to approve a plan to sell or close any of the facilities for which the carrying value exceeds fair market value, the Company would have to

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write off a portion of the assets or reduce the estimated useful life of the assets which would accelerate depreciation.

During the third quarter of 2006, the Company decided to proceed with the implementation of steps under its plan to streamline manufacturing activities in order to improve operating efficiency and reduce costs, including the decision to transfer the production of Levoxyl® from its St. Petersburg, Florida facility to its Bristol, Tennessee facility by the end of 2008. The Company believes that the assets associated with the St. Petersburg facility are not currently impaired based on estimated undiscounted cash flows associated with these assets. However, during the third quarter of 2006, the Company shortened the estimated useful lives of assets at the St. Petersburg facility and therefore accelerated the depreciation of these assets. For additional discussion, please see Note 13, Restructuring Activities.

6. Acquisitions, Co-Promotions and Alliances

On September 6, 2006, the Company entered into a definitive asset purchase agreement and related agreements with Ligand Pharmaceuticals Incorporated (Ligand) to acquire rights to Ligand s Avinza® (morphine sulfate extended release). Avinza® is an extended release formulation of morphine and is indicated as a once-daily treatment for moderate-to-severe pain in patients who require continuous, around-the-clock opioid therapy for an extended period of time. Under the terms of the asset purchase agreement, on the closing of the transaction the Company will make a $265,000 payment to Ligand to acquire all the rights to Avinza® in the United States, its territories and Canada. The closing payment is subject to adjustment based on Ligand s ability to reduce the wholesale and retail inventory levels of Avinza® to certain targeted levels by the closing date. In addition, the Company will assume certain liabilities, including a product related liability totaling $47,750.

As part of the transaction, the Company has agreed to pay Ligand an ongoing royalty, to assume payment of Ligand s royalty obligations to third parties. The royalty the Company will pay to Ligand consists of a 15% royalty during the first 20 months after the closing date, a subsequent royalty based upon calendar year net sales such that if calendar year net sales are less than $200,000 the royalty payment will be 5% of all net sales; if calendar year net sales are greater than $200,000 then the royalty payment will be 10% of all net sales up to $250,000, plus 15% of net sales greater than $250,000.

In connection with the transaction, on October 12, 2006, the Company entered into a loan agreement with Ligand for the amount of $37,750. The principal amount of the loan may be used solely for the purpose of paying a specific liability related to Avinza®. The loan is subject to certain market terms, including a 9.5% interest rate and security interest in the assets that comprise Avinza® and certain of the proceeds of Ligand s sale of certain assets. If the closing of the transaction occurs on or before January 8, 2007, the Company will forgive any accrued interest on the loan and the outstanding principal amount due thereunder would be credited against the purchase price for the Avinza® assets. If the closing of the transaction does not occur by January 8, 2007, the outstanding principal amount of the loan, accrued interest, as well as additional default interest of 2% from January 1, 2007 to January 8, 2007, would become due on January 9, 2007.

The transaction is conditioned upon the approval of Ligand s shareholders and other customary conditions. The Company anticipates that the transaction will close on or about December 31, 2006.

On June 22, 2000, the Company entered into a Co-Promotion Agreement with Wyeth to promote Altace® in the United States and Puerto Rico through October 29, 2008, with possible extensions as outlined in the Co-Promotion

Agreement. Under the agreement, Wyeth paid an upfront fee of $75,000 to King. In connection with the Co-Promotion Agreement, the Company agreed to pay Wyeth a promotional fee based on annual net sales of Altace®. On July 5, 2006 the Company entered into an Amended and Restated Co-Promotion Agreement (Amended Co-Promotion Agreement) with Wyeth regarding Altace®. Effective January 1, 2007, the Company will assume full responsibility for the selling and marketing of Altace®. For the remainder of

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2006, the Wyeth sales force will continue to promote the product with King and Wyeth will continue to share in the marketing expenses for the remainder of 2006. Under the Amended Co-Promotion Agreement, the Company will pay Wyeth a reduced annual fee as follows:

For 2006, 15% of Altace® net sales up to $165,000, 42.5% of Altace® net sales in excess of $165,000 and less than or equal to $465,000, and 52.5% of Altace® net sales that are in excess of $465,000 and less than or equal to $585,000. The fee in 2006 will not exceed $215,250.

For 2007, 30% of Altace® net sales, with the fee not to exceed $178,500.

For 2008, 22.5% of Altace® net sales, with the fee not to exceed $134,000.

For 2009, 14.2% of Altace® net sales, with the fee not to exceed $84,500.

For 2010, 25% of Altace® net sales, with the fee not to exceed $5,000.

The annual fee is accrued quarterly based on a percentage of Altace® net sales at a rate equal to the expected relationship of the expected fee for the year to applicable expected Altace® net sales for the year.

Wyeth will pay the Company a $20,000 milestone fee if a specified Altace® net sales threshold is achieved in 2008.

On March 1, 2006, the Company acquired the exclusive right to market and sell EpiPen® throughout Canada and other specific assets from Allerex Laboratory LTD. Under the terms of the agreements, the initial purchase price was $23,924, plus acquisition costs of $682. As an additional component of the purchase price, the Company will pay Allerex an earn-out equal to a percentage of future sales of EpiPen® in Canada over a fixed period of time. As these additional payments accrue, the Company will increase intangible assets by the amount of the accrual. The aggregate of these payments will not exceed $13,164.

The allocation of the initial purchase price is as follows:

Intangible assets	$ 23,985
Inventory	618
Fixed assets	3
	$ 24,606

At the time of the acquisition, the intangible assets were assigned useful lives of 9.8 years. The acquisition is allocated to the Meridian Medical Technologies segment. The Company financed the acquisition using available cash on hand.

On February 12, 2006, the Company entered into a collaboration with Arrow International Limited and certain of its affiliates (collectively, Arrow), not including Cobalt Pharmaceuticals, Inc., to commercialize novel formulations of ramipril, the active ingredient in the Company s Altace® product. Under a series of agreements, Arrow has granted

King rights to certain current and future New Drug Applications regarding novel formulations of ramipril and intellectual property, including patent rights and technology licenses relating to these novel formulations. Arrow will have responsibility for the manufacture and supply of the new formulations of ramipril for King. However, under certain conditions King may manufacture and supply the formulations of ramipril.

Upon execution of the agreements, King made an initial payment to Arrow of $35,000. Arrow will also receive payments from King of $75,000 based on the timing of certain events. Additionally, Arrow will earn fees for the manufacture and supply of the new formulations of ramipril.

In connection with the agreement with Arrow, the Company classified the initial payment of $35,000 and the future non-contingent payments of $50,000 as in-process research and development during the first quarter

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of 2006. During the third quarter of 2006, the conditions relating to the payment of an additional $25,000 licensing fee were met and the Company classified this additional future payment as in-process research and development expense. The value of the in-process research and development project was expensed as it had not received regulatory approval and had no alternative future use. The in-process research and development is part of the branded pharmaceutical segment. Arrow filed a New Drug Application (NDA) for a novel formulation of ramipril in January 2006. The success of the project will depend on additional development activities and FDA approval. The estimated costs to complete the project at the execution of the agreement was approximately $3,500. The Company currently anticipates obtaining FDA approval for the novel formulation during 2007 or 2008.

On February 12, 2006, the Company entered into an agreement with Cobalt Pharmaceuticals, Inc. (Cobalt), an affiliate of Arrow, whereby Cobalt has the non-exclusive right to distribute a generic formulation of the Company s currently marketed Altace® product in the U.S. market, which generic product would be supplied by King.

7. Intangible Assets and Goodwill

The following table reflects the components of intangible assets as of:

	September 30, 2006		December 31, 2005	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Trademarks and product rights	$ 1,199,545	$ 352,410	$ 1,174,028	$ 296,801
Patents	272,774	195,543	261,277	171,976
Other intangibles	9,459	8,997	9,459	8,793
Total intangible assets	$ 1,481,778	$ 556,950	$ 1,444,764	$ 477,570

Amortization expense for the three months ended September 30, 2006 and 2005 was $26,836 and $23,667, respectively. Amortization expense for the nine months ended September 30, 2006 and 2005 was $79,380 and $90,499, respectively.

As previously disclosed, a new competitor to Sonata® entered the market in April 2005. In the second quarter of 2005, the prescriptions for Sonata® did not meet expectations. As a result, the Company lowered its future sales forecast which decreased the estimated undiscounted future cash flows associated with the Sonata® intangible assets to a level below their carrying value. Accordingly, the Company recorded an intangible asset impairment charge of $126,923 during the second quarter of 2005 to adjust the carrying value of the Sonata® intangible assets on the Company s balance sheet to reflect the estimated fair value of these assets. The Company determined the fair value of the intangible assets associated with Sonata® based on its estimated discounted future cash flows. Sonata® is included in the Company s branded pharmaceuticals reporting segment.

As of September 30, 2006, the net intangible assets associated with Intal®, Tilade® and Synercid® products totals approximately $180,439. The Company believes that these intangible assets are not currently impaired based on estimated undiscounted cash flows associated with these assets. However, if the Company s estimates regarding future cash flows prove to be incorrect or adversely change, the Company may have to reduce the estimated remaining useful life and/or write off a portion or all of these intangible assets.

Goodwill at September 30, 2006 is as follows:

	Branded Segment	Meridian Segment	Total
Goodwill	$ 12,742	$ 108,410	$ 121,152

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8. Long-Term Debt

Long-term debt consists of the following:

	September 30, 2006	December 31, 2005
Convertible senior notes(a)	$ 400,000	$
Convertible debentures(b)	4,257	345,000
Senior secured revolving credit facility(c)		
Total long-term debt	404,257	345,000
Less current portion	4,257	345,000
Long-term portion	$ 400,000	$

(a) During the first quarter of 2006, the Company issued $400,000 of 11/4% Convertible Senior Notes due April 1, 2026 (Notes). The Notes are unsecured obligations and are guaranteed by each of the Company s domestic subsidiaries on a joint and several basis. The Notes accrue interest at an initial rate of 11/4%. Beginning with the six-month interest period that commences on April 1, 2013, the Company will pay additional interest during any six-month interest period if the average trading price of the Notes during the five consecutive trading days ending on the second trading day immediately preceding the first day of such six-month period equals 120% or more of the principal amount of the Notes. Interest is payable on April 1 and October 1 of each year, beginning October 1, 2006.

On or after April 5, 2013, the Company may redeem for cash some or all of the Notes at any time at a price equal to 100% of the principal amount of the Notes to be redeemed, plus any accrued and unpaid interest, and liquidated damages, if any, to but excluding the date fixed for redemption. Holders may require the Company to purchase for cash some or all of their Notes on April 1, 2013, April 1, 2016 and April 1, 2021, or upon the occurrence of a fundamental change (such as a change of control or a termination of trading), at 100% of the principal amount of the Notes to be purchased, plus any accrued and unpaid interest, and liquidated damages, if any, to but excluding the purchase date.

Prior to April 1, 2012, the Notes are convertible under the following circumstances:

if the price of the Company s common stock reaches a specified threshold during specified periods,

if the Notes have been called for redemption, or

if specified corporate transactions or other specified events occur.

The Notes are convertible at any time on and after April 1, 2012, until the close of business on the business day immediately preceding maturity. Subject to certain exceptions, the Company will deliver cash and shares of the Company s common stock, as follows: (i) an amount in cash equal to the lesser of (a) the principal amount of Notes surrendered for conversion and (b) the product of the conversion rate and the average price of the Company s common stock (the conversion value), and (ii) if the conversion value is greater than the principal amount, a specified amount in cash or shares of the Company s common stock, at the Company s election. The initial conversion price is approximately $20.83 per share of common stock. If certain corporate transactions occur on or prior to April 1, 2013, the Company will increase the conversion rate in certain circumstances.

The Company has reserved 23,732,724 shares of common stock in the event the Notes are converted into shares of the Company s common stock.

In connection with the issuance of the Notes, the Company incurred approximately $10,786 of deferred financing costs that are being amortized over seven years.

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(b) During the fourth quarter of 2001, the Company issued $345,000 of 23/4% Convertible Debentures due November 15, 2021 (Debentures). On March 29, 2006, the Company repurchased $165,000 of the Debentures prior to maturity for $163,350, resulting in a gain of $1,650. In addition, the Company wrote off deferred financing costs of $628 relating to the repurchased Debentures. On June 2, 2006, the Company completed a tender offer, repurchasing $175,743 of the Debentures at a purchase price of $175,084, resulting in a gain of $659. In addition, the Company wrote off financing costs of $983 relating to the repurchased Debentures. On May 16, 2006, the interest rate on the Debentures was reset to 3.5%. On October 6, 2006, the Company sent a notice of redemption to the trustee of the Debentures that it will redeem all of the outstanding Debentures on November 20, 2006. In accordance with the optional redemption provisions of the indenture of the Debentures, the Company will redeem the Debentures at a price of 100% of the principal amount thereof plus accrued interest.

(c) On April 23, 2002, the Company established a $400,000 five year Senior Secured Revolving Credit Facility which matures in April 2007.

9. Contingencies

Fen/Phen Litigation

Many distributors, marketers and manufacturers of anorexigenic drugs have been subject to claims relating to the use of these drugs. Generally, the lawsuits allege that the defendants (1) misled users of the products with respect to the dangers associated with them, (2) failed to adequately test the products and (3) knew or should have known about the negative effects of the drugs, and should have informed the public about the risks of such negative effects. Claims include product liability, breach of warranty, misrepresentation and negligence. The actions have been filed in various state and federal jurisdictions throughout the United States. A multi-district litigation (MDL) court has been established in Philadelphia, Pennsylvania, *In re* Fen-Phen Litigation. The plaintiffs seek, among other things, compensatory and punitive damages and/or court-supervised medical monitoring of persons who have ingested the product.

The Company s wholly-owned subsidiary, King Pharmaceuticals Research and Development, Inc. (King Research and Development), is a defendant in approximately 128 multi-plaintiff (1,657 plaintiffs) lawsuits involving the manufacture and sale of dexfenfluramine, fenfluramine and phentermine. These lawsuits have been filed in various jurisdictions throughout the United States and in each of these lawsuits King Research and Development, as the successor to Jones Pharma, Incorporated (Jones), is one of many defendants, including manufacturers and other distributors of these drugs. Although Jones did not at any time manufacture dexfenfluramine, fenfluramine, or phentermine, Jones was a distributor of a generic phentermine product and, after its acquisition of Abana Pharmaceuticals, was a distributor of Obenix®, Abana s branded phentermine product. The manufacturer of the phentermine purchased by Jones has filed for bankruptcy protection and is no longer in business. The plaintiffs in these cases, in addition to the claims described above, claim injury as a result of ingesting a combination of these weight-loss drugs and are seeking compensatory and punitive damages as well as medical care and court-supervised medical monitoring. The plaintiffs claim liability based on a variety of theories, including, but not limited to, product liability, strict liability, negligence, breach of warranty, fraud and misrepresentation.

King Research and Development denies any liability incident to Jones distribution of Obenix® or Jones generic phentermine product. King Research and Development s insurance carriers are currently defending King Research and Development in these lawsuits. The manufacturers of fenfluramine and dexfenfluramine have settled many of these cases. As a result of these settlements, King Research and Development has routinely received voluntarily dismissals without the payment of settlement proceeds. In the event that King Research and Development s insurance coverage is inadequate to satisfy any resulting liability, King Research and Development will have to assume defense of these lawsuits and be responsible for the damages, if any, that are awarded against it.

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While the Company cannot predict the outcome of these lawsuits, management believes that the claims against King Research and Development are without merit and intends to vigorously pursue all defenses available. The Company is unable to disclose an aggregate dollar amount of damages claimed because many of these complaints are multi-party suits and do not state specific damage amounts. Rather, these claims typically state damages as may be determined by the court or similar language and state no specific amount of damages against King Research and Development. Consequently, the Company cannot reasonably estimate possible losses related to the lawsuits.

In addition, the Company is one of many defendants in six multi-plaintiff lawsuits that claim damages for personal injury arising from its production of the anorexigenic drug phentermine under contract for GlaxoSmithKline. While the Company cannot predict the outcome of these suits, the Company believes that the claims against it are without merit and the Company intends to vigorously pursue all defenses available to it. The Company is being indemnified in the six lawsuits by GlaxoSmithKline, for which the Company manufactured the anorexigenic product, provided that neither the lawsuits nor the associated liabilities are based upon the Company s independent negligence or intentional acts. The Company intends to submit a claim for any unreimbursed costs to its product liability insurance carrier. However, in the event that GlaxoSmithKline is unable to satisfy or fulfill its obligations under the indemnity, the Company would have to assume defense of the lawsuits and be responsible for damages, if any, that are awarded against it or for amounts in excess of the Company s product liability coverage. A reasonable estimate of possible losses related to these suits cannot be made.

Thimerosal/Children s Vaccine Related Litigation

The Company and Parkedale Pharmaceuticals, Inc., a wholly-owned subsidiary of the Company, are named as defendants in lawsuits filed in California, Mississippi and Illinois (Madison County), along with other pharmaceutical companies. The first of these suits was filed in November 2001. Most of the defendants manufactured or sold the mercury-based preservative thimerosal or manufactured or sold children s vaccines containing thimerosal. The Company did not manufacture thimerosal or manufacture or sell a children s vaccine that contained thimerosal. For two years the Company did manufacture and sell an influenza vaccine that contained thimerosal. None of the plaintiffs has alleged taking our influenza vaccine.

In these cases, the plaintiffs have attempted to link the receipt of mercury-based products to neurological defects in children. The plaintiffs claim unfair business practices, fraudulent misrepresentations, negligent misrepresentations, product liability, Proposition 65 violations, breach of implied warranty, and claims premised on the allegation that the defendants promoted products without any reference to the toxic hazards and potential public health ramifications resulting from the mercury-containing preservative. The plaintiffs also allege that the defendants knew of the dangerous propensities of thimerosal in their products.

The Company has given its product liability insurance carrier proper notice of all of these matters and defense counsel is vigorously defending the Company s interests. The Company has filed motions to dismiss based on the Federal Vaccine Act and lack of product identification. The Company was voluntarily dismissed in Mississippi due, among other things, to lack of product identification in the plaintiffs complaints. The Company was voluntarily dismissed in the only case filed in Chicago and motions to dismiss based on the Vaccine Act are still pending in all of the remaining Illinois cases. The California Proposition 65 claims were dismissed in the California Trial Court. This dismissal was affirmed in the California Court of Appeals and no further appeals were filed. Subsequent Proposition 65 claims were dismissed. Management believes that the claims against the Company are without merit and the Company intends to defend these lawsuits vigorously, but the Company is unable currently to predict the outcome or

to reasonably estimate the range of potential loss, if any.

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Hormone Replacement Therapy

Currently, the Company is named as a defendant in 23 lawsuits involving the manufacture and sale of hormone replacement therapy drugs. The first of these suits was filed in July 2004. Numerous pharmaceutical companies have also been sued. The Company was also named in several large multiple plaintiff lawsuits, but those multiple plaintiff cases were voluntarily dismissed or dismissed by the Court for lack of product identification. These remaining 23 lawsuits were filed in Alabama, Arkansas, Missouri, Pennsylvania, Ohio, Minnesota, Florida, Maryland, Mississippi and Minnesota. An MDL Court has been established in Little Rock, Arkansas, *In re:* Prempro Products Liability Litigation, and all of the plaintiffs claims are pending in that Court except for one lawsuit pending in Philadelphia, Pennsylvania State Court. Many of these plaintiffs allege that the Company and other defendants failed to conduct adequate research and testing before the sale of the products and post-sale surveillance to establish the safety and efficacy of the long-term hormone therapy regimen and, as a result, misled consumers when marketing their products. Plaintiffs also allege negligence, strict liability, design defect, breach of implied warranty, breach of express warranty, fraud and misrepresentation. Discovery of the plaintiffs claims against the Company has begun but is in early stages. Two cases involving a co-defendant were tried during 2006. The first MDL trial resulted in a defense verdict for co-defendant Wyeth, the manufacturer of Prempro, in September 2006. The first state court trial in Pennsylvania was to be tried in two phases. The plaintiff won the first phase and the potential verdict was $1,500, but that verdict was dismissed because the trial Judge declared a mistrial based upon a sealed motion filed with the court in October 2006. The Company does not expect to have any trials set in 2007, as the current trial calendars include trials against co-defendants in 2007. The Company intends to defend these lawsuits vigorously but is currently unable to predict the outcome or to reasonably estimate the range of potential loss, if any. The Company may have limited insurance for these claims.

Average Wholesale Price Litigation

In August 2004, King and Monarch Pharmaceuticals, Inc. (Monarch), a wholly-owned subsidiary of King, were named as defendants along with 44 other pharmaceutical manufacturers in an action brought by the City of New York (NYC) in federal court in the state of New York. NYC claims that the defendants fraudulently inflated their average wholesale prices (AWP) and fraudulently failed to accurately report their best prices and their average manufacturer s prices and failed to pay proper rebates pursuant to federal law. Additional claims allege violations of federal and New York statutes, fraud and unjust enrichment. For the period from 1992 to the present, NYC is requesting money damages, civil penalties, declaratory and injunctive relief, restitution, disgorgement of profits, and treble and punitive damages. The United States District Court for the District of Massachusetts has been established as the MDL court for the case, *In re:* Pharmaceutical Industry Average Wholesale Pricing Litigation.

Since the filing of the New York City case, forty three New York counties have filed lawsuits against the pharmaceutical industry, including the Company and Monarch. Forty of these lawsuits are pending in the MDL Court in the District of Massachusetts. The remaining 3 cases were filed in Erie, Oswego and Schenectady Counties in the New York State Courts. A co-defendant removed these 3 cases to Federal Court on October 11, 2006. The allegations in these cases are virtually the same as the allegations in the New York City case. Motions to dismiss have been filed by all defendants in all New York City and County cases pending in the MDL and in the Erie County case. The Erie motion to dismiss was granted in part and denied in part. The MDL Court has not ruled on the motions pending in the remaining cases.

In January 2005, the State of Alabama filed a lawsuit in State Court against 79 defendants including the Company and Monarch. The four causes of action center on the allegation that all defendants fraudulently inflated AWPs of their products. In October 2005, the State of Mississippi filed a lawsuit in State Court against the Company, Monarch and eighty-four other defendants and alleged fourteen causes of action. Many of those causes of action allege that all defendants fraudulently inflated the AWPs and wholesale acquisition costs (WACs) of their products. A motion to dismiss the allegations based upon criminal statutes, a motion

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to transfer venue from Hinds County to Rankin County, a motion for protective order regarding discovery, a motion for more definite statement and other motions were filed in the Court in Mississippi. A Motion to Dismiss the criminal statute counts and a Motion For More Definite Statement were granted. Mississippi was required to file an amended complaint and in doing so dismissed the Company and Monarch from the lawsuit without prejudice. In Alabama, a motion to dismiss was filed and denied by the court, but the Court did require an amended complaint to be filed. The Company filed an answer and counter-claim for return of rebates overpaid to the State. Alabama filed a motion to dismiss the counter-claim which was granted. The Company perfected its appeal of that ruling. A co-defendant removed the Alabama and Mississippi cases to Federal Court on October 11, 2006. The Alabama case was remanded to state court on November 2, 2006. These two cases are in early stages of discovery. The relief sought in both of these cases is similar to the relief sought in the New York City lawsuit. The Company intends to defend all of the AWP lawsuits vigorously but is currently unable to predict the outcome or reasonably estimate the range of potential loss, if any.

Settlement of Governmental Pricing Investigation

On October 31, 2005, the Company entered into (i) a definitive settlement agreement with the United States of America, acting through the United States Department of Justice and the United States Attorney s Office for the Eastern District of Pennsylvania and on behalf of the Office of Inspector General of the United States Department of Health and Human Services (HHS/OIG) and the Department of Veterans Affairs, to resolve the governmental investigations related to the Company s underpayment of rebates owed to Medicaid and other governmental pricing programs during the period from 1994 to 2002 (the Federal Settlement Agreement), and (ii) similar settlement agreements with 48 states and the District of Columbia (collectively, the 2005 State Settlement Agreements). On March 6, 2006, the Company entered into a definitive settlement agreement with the remaining state on substantially the same terms as the other state settlements (this most recent state settlement, the Federal Settlement Agreement and the 2005 State Settlement Agreements are collectively referred to as the Settlement Agreements). Consummation of the Federal Settlement Agreement and some state Settlement Agreements was subject to court approval, which was granted by the United States District Court for the Eastern District of Pennsylvania (District Court) during the first quarter of 2006.

During the first quarter of 2006, the Company paid approximately $129,268, comprising (i) all amounts due under each of the Settlement Agreements and (ii) all the Company s obligations to reimburse other parties for expenses related to the settlement, including the previously disclosed legal fees of approximately $787 and the previously disclosed settlement costs of approximately $950.

The individual purportedly acting as a relator under the False Claims Act has appealed certain decisions of the District Court denying the relator s request to be compensated out of the approximately $31,000 that was paid by the Company to those states that do not have legislation providing for a relator s share. The purported relator has asserted for the first time on appeal that the Company should be responsible for making such a payment to this individual. The Company believes that this claim against it is without merit and does not expect the result of the appeal to have a material effect on it.

In addition to the Settlement Agreements, the Company has entered into a five-year corporate integrity agreement with HHS/OIG (the Corporate Integrity Agreement) pursuant to which the Company is required, among other things, to keep in place the Company s current compliance program, to provide periodic reports to HHS/OIG and to submit to audits relating to the Company s Medicaid rebate calculations.

The previously disclosed claim seeking damages from the Company because of alleged retaliatory actions against the relator was dismissed with prejudice on January 31, 2006.

The Settlement Agreements will not resolve any of the previously disclosed civil suits that are pending against the Company and related individuals and entities discussed in the section Securities Litigation below.

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SEC Investigation

As previously reported, the Securities and Exchange Commission (SEC) has also been conducting an investigation relating to the Company s underpayments to governmental programs, as well as into the Company s previously disclosed errors relating to reserves for product returns. While the SEC s investigation is continuing with respect to the product returns issue, the Staff of the SEC has advised the Company that it has determined not to recommend enforcement action against the Company with respect to the aforementioned governmental pricing matter. The Staff of the SEC notified the Company of this determination pursuant to the final paragraph of Securities Act Release 5310. Although the SEC could still consider charges against individuals in connection with the governmental pricing matter, the Company does not believe that any governmental unit with authority to assert criminal charges is considering any charges of that kind.

The Company continues to cooperate with the SEC s ongoing investigation. Based on all information currently available to it, the Company does not anticipate that the results of the SEC s ongoing investigation will have a material adverse effect on King, including by virtue of any obligations to indemnify current or former officers and directors.

Securities Litigation

Subsequent to the announcement of the SEC investigation described above, beginning in March 2003, 22 purported class action complaints were filed by holders of the Company s securities against the Company, its directors, former directors, executive officers, former executive officers, a Company subsidiary, and a former director of the subsidiary in the United States District Court for the Eastern District of Tennessee, alleging violations of the Securities Act of 1933 and/or the Securities Exchange Act of 1934, in connection with the Company s underpayment of rebates owed to Medicaid and other governmental pricing programs, and certain transactions between the Company and the Benevolent Fund, a nonprofit organization affiliated with certain former members of the Company s senior management. These 22 complaints have been consolidated in the United States District Court for the Eastern District of Tennessee. In addition, holders of the Company s securities filed two class action complaints alleging violations of the Securities Act of 1933 in Tennessee state court. The Company removed these two cases to the United States District Court for the Eastern District of Tennessee, where these two cases were consolidated with the other class actions. The district court has appointed lead plaintiffs in the consolidated action, and those lead plaintiffs filed a consolidated amended complaint on October 21, 2003 alleging that King, through some of its executive officers, former executive officers, directors, and former directors, made false or misleading statements concerning its business, financial condition, and results of operations during periods beginning February 16, 1999 and continuing until March 10, 2003. Plaintiffs in the consolidated action have also named the underwriters of King s November 2001 public offering as defendants. The Company and other defendants filed motions to dismiss the consolidated amended complaint.

On August 12, 2004, the United States District Court for the Eastern District of Tennessee ruled on defendants motions to dismiss. The Court dismissed all claims as to Jones and as to defendants Dennis Jones and Henry Richards. The Court also dismissed certain claims as to five other individual defendants. The Court denied the motions to dismiss in all other respects. Following the Court s ruling, on September 20, 2004, the Company and the other remaining defendants filed answers to plaintiffs consolidated amended complaint.

In November 2005, the parties agreed to submit the matter to non-binding mediation. After an extensive mediation process, an agreement in principle to settle the litigation was reached on April 26, 2006. On July 31, 2006, the parties

entered into a stipulation of settlement and a supplemental agreement (together, the Settlement Agreement) to resolve the litigation. On September 27, 2006, the court granted preliminary approval of the Settlement Agreement. Consummation of the Settlement Agreement is still subject to certain conditions, including, among others, final court approval. The Settlement Agreement provides for a settlement amount of $38,250. Prior to the Settlement Agreement, the Court established April 10, 2007 as the trial date.

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The Company previously estimated a probable loss contingency of $38,250 for the class action lawsuit described above. The Company believes all but an immaterial portion of this loss contingency will be paid on behalf of the Company by its insurance carriers. Accordingly, the Company previously recorded a liability and a receivable for this amount, which are classified in accrued expenses and prepaid and other current assets, respectively, in the accompanying consolidated financial statements.

Beginning in March 2003, four purported shareholder derivative complaints were also filed in Tennessee state court alleging a breach of fiduciary duty, among other things, by some of the Company s current and former officers and directors, with respect to the same events at issue in the federal securities litigation described above. These cases have been consolidated, and on October 3, 2003, plaintiffs filed a consolidated amended complaint. On November 17, 2003, defendants filed a motion to dismiss or stay the consolidated amended complaint. The court denied the motion to dismiss, but granted a stay of proceedings. On October 11, 2004, the court lifted the stay to permit plaintiffs to file a further amended complaint adding class action claims related to the Company s then-anticipated merger with Mylan Laboratories, Inc. On October 26, 2004, defendants filed a partial answer to the further amended complaint, and moved to dismiss the newly-added claims. Following the termination of the Mylan merger agreement, plaintiffs voluntarily dismissed these claims. On October 11, 2006, plaintiffs voluntarily dismissed claims against Brian Markison and Elizabeth Greetham. Discovery with respect to the remaining claims in the case has commenced. No trial date has been set.

Beginning in March 2003, three purported shareholder derivative complaints were likewise filed in Tennessee federal court, asserting claims similar to those alleged in the state derivative litigation. These cases have been consolidated, and on December 2, 2003 plaintiffs filed a consolidated amended complaint. On March 9, 2004, the court entered an order indefinitely staying these cases in favor of the state derivative action.

In August 2004, a separate class action lawsuit was filed in Tennessee state court, asserting claims solely with respect to the Company s then-anticipated merger with Mylan Laboratories. Defendants filed a motion to dismiss the case on November 30, 2004. On March 14, 2006, plaintiff dismissed the case. On June 12, 2006, Plaintiff filed a motion requesting an award of attorneys fees and expenses in the amount of $1,500. On October 18, 2006, plaintiffs modified their motion asking the court to determine whether plaintiffs are entitled to an award of reasonable attorneys fees and expenses. This motion is pending.

During the third quarter of 2006, the Company recorded an anticipated insurance recovery of legal fees in the amount of $6,750 for the class action and derivative suits described above, which is classified in prepaid and other current assets in the accompanying financial statements. In November of 2006, the Company received payment for the recovery of these legal fees.

The Company is unable currently to predict the outcome or reasonably estimate the range of potential loss, if any, except as noted above, in the pending litigation. If the Company were not to prevail in the pending litigation, which it cannot predict or reasonably estimate at this time, its business, financial condition, results of operations and cash flows could be materially adversely affected. Defending the Company in the pending litigation has resulted, and is expected to continue to result, in a significant diversion of management s attention and resources and the payment of additional professional fees.

Other Legal Proceedings

Cobalt Pharmaceuticals, Inc. (Cobalt), a generic drug manufacturer located in Mississauga, Ontario, Canada, filed an Abbreviated New Drug Application (ANDA) with the U.S. Food and Drug Administration (the FDA) seeking permission to market a generic version of Altace®. The following U.S. patents are listed for Altace® in the FDA s *Approved Drug Products With Therapeutic Equivalence Evaluations* (the Orange Book): United States Patent No. 5,061,722 (the 722 patent), a composition of matter patent and United States Patent No. 5,403,856 (the 856 patent), a method-of-use patent, with expiration dates of October 2008 and April 2012, respectively. Under the federal Hatch-Waxman Act of 1984, any generic

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manufacturer may file an ANDA with a certification (a Paragraph IV certification) challenging the validity or infringement of a patent listed in the FDA s Orange Book four years after the pioneer company obtains approval of its New Drug Application (NDA). Cobalt filed a Paragraph IV certification alleging invalidity of the 722 patent, and Aventis Pharma Deutschland GmbH (Aventis) and the Company filed suit on March 14, 2003 in the District Court for the District of Massachusetts to enforce its rights under that patent. Pursuant to the Hatch-Waxman Act, the filing of that suit provided the Company an automatic stay of FDA approval of Cobalt s ANDA for 30 months (unless the patents are held invalid, unenforceable, or not infringed) from no earlier than February 5, 2003. That 30 month stay expired in August 2005 and on October 24, 2005, the FDA granted final approval of Cobalt s ANDA. In March 2004, Cobalt stipulated to infringement of the 722 patent. Subsequent to filing its original complaint, the Company amended its complaint to add an allegation of infringement of the 856 patent. The 856 patent covers one of Altace® s three indications for use. In response to the amended complaint, Cobalt informed the FDA that it no longer seeks approval to market its proposed product for the indication covered by the 856 patent. On this basis, the court granted Cobalt summary judgment of non-infringement of the 856 patent. The court s decision does not affect Cobalt s infringement of the 722 patent. The parties submitted a joint stipulation of dismissal on April 4, 2006, and the Court granted dismissal.

The Company has received a request for information from the U.S. Federal Trade Commission (FTC) in connection with the dismissal without prejudice of the Company s patent infringement litigation against Cobalt under the Hatch-Waxman Act of 1984. The Company is cooperating with the FTC in this investigation.

Lupin Ltd. (Lupin) filed an ANDA with the FDA seeking permission to market a generic version of Altace® (Lupin s ANDA). In addition to its ANDA, Lupin filed a Paragraph IV certification challenging the validity and infringement of the 722 patent, and seeking to market its generic version of Altace® before expiration of the 722 patent. In July 2005, the Company filed civil actions for infringement of the 722 patent against Lupin in the U.S. District Courts for the District of Maryland and the Eastern District of Virginia. Pursuant to the Hatch-Waxman Act, the filing of the lawsuit against Lupin provides the Company with an automatic stay of FDA approval of Lupin s ANDA for up to 30 months (unless the patents are held invalid, unenforceable, or not infringed) from no earlier than June 8, 2005. On February 1, 2006, the Maryland and Virginia cases were consolidated into a single action in the Eastern District of Virginia. On June 5, 2006, the Court granted King summary judgment and found Lupin to infringe the 722 patent. On June 14, 2006, during the trial, the Court dismissed Lupin s unenforceability claims as a matter of law, finding the 722 patent enforceable. On July 18, 2006, the Court upheld the validity of the 722 patent. Lupin filed a notice of appeal on July 19, 2006.

The Company intends to vigorously enforce its rights under the 722 and 856 patents. If a generic version of Altace® enters the market, the Company s business, financial condition, results of operations and cash flows could be materially adversely affected. As of September 30, 2006, the Company had net intangible assets related to Altace® of $230,922. If a generic version of Altace® enters the market, the Company may have to write off a portion or all of the intangible assets associated with this product.

Eon Labs, Inc. (Eon Labs), CorePharma, LLC (CorePharma) and Mutual Pharmaceutical Co., Inc. (Mutual) have each filed an ANDA with the FDA seeking permission to market a generic version of Skelaxin® 400 mg tablets. Additionally, Eon Labs ANDA seeks permission to market a generic version of Skelaxin® 800 mg tablets. United States Patent Nos. 6,407,128 (the 128 patent) and 6,683,102 (the 102 patent), two method-of-use patents relating to Skelaxin®, are listed in the FDA s Orange Book and do not expire until December 3, 2021. Eon Labs and CorePharma have each filed Paragraph IV certifications against the 128 and 102 patents and are alleging noninfringement, invalidity and unenforceability of those patents. Mutual has filed a Paragraph IV certification against the 102 patent

alleging noninfringement and invalidity of that patent. A patent infringement suit was filed against Eon Labs on January 2, 2003 in the District Court for the Eastern District of New York; against CorePharma on March 7, 2003 in the District Court for the District of New Jersey (subsequently transferred to the District Court for the Eastern District of

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New York); and against Mutual on March 12, 2004 in the District Court for the Eastern District of Pennsylvania concerning their proposed 400 mg products. Additionally, the Company filed a separate suit against Eon Labs on December 17, 2004 in the District Court for the Eastern District of New York, concerning its proposed 800 mg product. Pursuant to the Hatch-Waxman Act, the filing of the suit against CorePharma provided the Company with an automatic stay of FDA approval of CorePharma s ANDA for 30 months (unless the patents are held invalid, unenforceable, or not infringed) from no earlier than January 24, 2003. That 30 month stay expired in July 2005. Also pursuant to the Hatch-Waxman Act, the filing of the suits against Eon Labs provided the Company with an automatic stay of FDA approval of Eon Labs ANDA for its proposed 400 mg and 800 mg products for 30 months (unless the patents are held invalid, unenforceable, or not infringed) from no earlier than November 18, 2002 and November 3, 2004, respectively. The 30 month stay of FDA approval for Eon Labs ANDA for its proposed 400 mg product expired in May 2005. On May 17, 2006, the District Court for the Eastern District of Pennsylvania placed the Mutual case on the Civil Suspense Calendar pending the outcome of the FDA activity described below. On June 16, 2006, the District Court for the Eastern District of New York consolidated the Eon Labs cases with the CorePharma case. The Company intends to vigorously enforce its rights under the 128 and 102 patents to the full extent of the law.

On March 9, 2004, the Company received a copy of a letter from the FDA to all ANDA applicants for Skelaxin® stating that the use listed in the FDA s Orange Book for the 128 patent may be deleted from the ANDA applicants product labeling. The Company believes that this decision is arbitrary, capricious, and inconsistent with the FDA s previous position on this issue. The Company filed a Citizen Petition on March 18, 2004 (supplemented on April 15, 2004 and on July 21, 2004), requesting the FDA to rescind that letter, require generic applicants to submit Paragraph IV certifications for the 128 patent, and prohibit the removal of information corresponding to the use listed in the Orange Book. King concurrently filed a Petition for Stay of Action requesting the FDA to stay approval of any generic metaxalone products until the FDA has fully evaluated the Company s Citizen Petition.

On March 12, 2004, the FDA sent a letter to the Company explaining that King s proposed labeling revision for Skelaxin®, which includes references to additional clinical studies relating to food, age, and gender effects, was approvable and only required certain formatting changes. On April 5, 2004, the Company submitted amended labeling text that incorporated those changes. On April 5, 2004, Mutual filed a Petition for Stay of Action requesting the FDA to stay approval of the Company s proposed labeling revision until the FDA has fully evaluated and ruled upon the Company s Citizen Petition, as well as all comments submitted in response to that petition. Discussions with the FDA concerning appropriate labeling are ongoing. The Company, CorePharma and Mutual have filed responses and supplements to their pending Citizen Petitions and responses. On December 8, 2005, Mutual filed another supplement with the FDA in which it withdrew its prior Petition for Stay, supplement, and opposition to King s Citizen Petition.

If the Company s Citizen Petition is rejected, there is a substantial likelihood that a generic version of Skelaxin® will enter the market, and the Company s business, financial condition, results of operations and cash flows could be materially adversely affected. As of September 30, 2006, the Company had net intangible assets related to Skelaxin® of $158,723. If demand for Skelaxin® declines below current expectations, the Company may have to write off a portion or all of these intangible assets.

The Company has entered into an agreement with a generic pharmaceutical company to launch an authorized generic version of Skelaxin in the event the Company faces generic competition for Skelaxin. However, the Company cannot provide any assurance regarding the extent to which this strategy will be successful, if at all.

Sicor Pharmaceuticals, Inc. (Sicor Pharma), a generic drug manufacturer located in Irvine California, filed an ANDA with the FDA seeking permission to market a generic version of Adenoscan®. U.S. Patent No. 5,070,877 (the 877 patent), a method-of-use patent with an expiration date of May 2009, is assigned to King and listed in the FDA s Orange Book entry for Adenoscan®. Astellas Pharma US, Inc. (Astellas) is the exclusive licensee of certain rights under the 877 patent and has marketed Adenoscan® in the U.S. since

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1995. A substantial portion of the Company s revenues from its royalties segment is derived from Astellas based on its net sales of Adenoscan®. Sicor Pharma has filed a Paragraph IV certification alleging invalidity of the 877 patent and non-infringement of certain claims of the 877 patent. King and Astellas filed suit against Sicor Pharma and its parents/affiliates Sicor, Inc., Teva Pharmaceuticals USA, Inc. (Teva) and Teva Pharmaceutical Industries, Ltd., on May 26, 2005, in the United States District Court for the District of Delaware to enforce their rights under the 877 patent. Pursuant to the Hatch-Waxman Act, the filing of that suit provides the Company an automatic stay of FDA approval of Sicor Pharma s ANDA for 30 months (unless the patents are held invalid, unenforceable, or not infringed) from no earlier than April 16, 2005. On May 16, 2006, Sicor Pharma stipulated to infringement of the asserted claims of the 877 patent. Trial in this action is currently scheduled to begin on February 12, 2007. The Company intends to vigorously enforce its rights under the 877 patent. Sicor is also involved in litigation with Item Development AB regarding U.S. Patent No. 5,731,296, a method-of-use patent with an expiration date of March 2015, which is also listed in the Orange Book for Adenoscan®. If a generic version of Adenoscan® enters the market, the Company s business, financial condition, results of operations and cash flows could be materially adversely affected.

Teva filed an ANDA with the FDA seeking permission to market a generic version of Sonata®. In addition to its ANDA, Teva filed a Paragraph IV certification challenging the enforceability of U.S. Patent 4,626,538 (the 538 patent) listed in the Orange Book, a composition of matter patent which expires in June 2008. In August 2005, King filed suit against Teva in the United States District Court for the District of New Jersey to enforce its rights under the 538 patent. Pursuant to the Hatch-Waxman Act, the filing of that suit provides the Company an automatic stay of FDA approval of Teva s ANDA for 30 months (unless the patents are held invalid, unenforceable, or not infringed) from no earlier than June 21, 2005. On September 25, 2006, the parties filed a stipulation with the Court in which Teva admitted infringement of the 538 patent. The Company intends to vigorously enforce its rights under the 538 patent. As of September 30, 2006, the Company had net intangible assets related to Sonata® of $2,801. If a generic form of Sonata® enters the market, the Company s business, financial condition, results of operations and cash flows could be materially adversely affected.

In addition to the matters discussed above, the Company is involved in various other legal proceedings incident to the ordinary course of its business. The Company does not believe that unfavorable outcomes as a result of these other legal proceedings would have a material adverse effect on its financial position, results of operations and cash flows.

Other Contingencies

The Company has a supply agreement with a third party to produce ramipril, the active ingredient in Altace®. This supply agreement requires the Company to purchase certain minimum levels of ramipril as long as the Company maintains market exclusivity on Altace® in the United States, and thereafter the parties must negotiate in good faith the annual minimum purchase quantities. If the Company is unable to maintain market exclusivity for Altace® in accordance with current expectations and/or if the Company s product life cycle management is not successful, the Company may incur losses in connection with the purchase commitments under the supply agreement. In the event the Company incurs losses in connection with the purchase commitments under the supply agreement, there may be a material adverse effect upon the Company s results of operations and cash flows.

10. Accounting Developments

The Company adopted Statement of Financial Accounting Standards No. 123(R), Share-Based Payment, January 1, 2006. See Note 2 for further discussion.

In November 2004, the Financial Accounting Standards Board issued SFAS No. 151, Inventory Costs , an amendment of Accounting Research Bulletin No. 43. SFAS No. 151 requires certain production overhead costs to be allocated to inventory based upon the normal capacity of the manufacturing facility. When the Company s manufacturing facilities are operating below their normal capacity, unfavorable variances cannot be

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allocated to inventory and must be expensed in the period in which they are incurred. Normal capacity is not defined as full capacity by SFAS No. 151. SFAS No. 151 instead provides that normal capacity refers to a range of production levels expected to be achieved over a number of periods or seasons under normal circumstances. The Company believes all of its operating facilities, except for the Rochester, Michigan facility, are currently operating at levels considered to be normal capacity as defined by SFAS No. 151 as these plants have operated at their current levels for a number of periods and are expected to continue to operate within a range of this normal capacity in the foreseeable future. The margins provided by branded pharmaceutical products are such that they allow manufacturers to operate facilities at lower volumes, or at volumes below theoretical capacity. Additionally, lower capacity levels at certain facilities are, at times, due to the complexity and high regulatory standards associated with the pharmaceutical manufacturing process. With respect to the Bristol, Tennessee facility, the Company anticipates no abnormally higher or lower production levels in the current year and, therefore, has concluded that the projected level of production is within a range of normal capacity, and the margins on the branded pharmaceutical products produced at this facility will result in an adequate return on the Company s investment. Consequently, the Company believes that it is appropriate to use the expected production level to allocate fixed production overhead. The Rochester facility is currently operating at a level below normal capacity primarily due to a decline in contract manufacturing in recent years. The company-owned products manufactured at this facility are not among the Company s higher margin products. In 2003, the Company began expensing, and continues to expense, a portion of the fixed overhead costs of this facility as period costs in accordance with Accounting Research Bulletin No. 43. Accordingly, the adoption of SFAS No. 151, as of January 1, 2006, did not have an incremental effect on the Company s financial statements.

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109* (FIN 48), which clarifies the accounting for uncertainty in tax positions. The provisions of FIN 48 are effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the effect of FIN 48 on its financial statements and currently plans to adopt this interpretation in the first quarter of 2007.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS No. 157). This statement defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. The statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is in the process of evaluating the effect of SFAS No. 157 on its financial statements and currently plans to adopt this standard in the first quarter of 2008.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB statements No. 87, 88, 106, and 132(R) (SFAS No. 158). This statement amends the guidance in various standards related to pensions and other postretirement benefit plans. In addition to new disclosure requirements, this statement requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. This statement also requires the measurement of defined benefit plan assets and obligations as of the date of the employer s fiscal year-end statement of financial position. The disclosure and recognition requirements of this statement become effective as of the end of the fiscal year ending after December 15, 2006 while the requirement to measure plan assets and benefit obligations as of the date of the employer s fiscal year-end is effective for fiscal years ending after December 15, 2008. The Company is in the process of evaluating the effect of SFAS No. 158 on its financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements for the Purpose of a Materiality Assessment, (SAB 108) which was issued in order to eliminate the diversity of practice in

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quantifying financial statement misstatements. It requires quantification of financial statement misstatements based on the effects of the misstatements on each of the company s financial statements and the related financial statement disclosures. The provisions of SAB 108 must be applied to annual financial statements no later than the first fiscal year ending after November 15, 2006. The Company has assessed the effect of adopting this guidance and has determined that there will be no impact on its financial statements.

11. Income Taxes

The effective tax rate varies from the statutory rate for the three and nine months ended September 30, 2006 due primarily to tax benefits related to charitable contributions of inventory, tax-exempt interest income, and domestic manufacturing deductions, which benefits were partially offset by state taxes.

The effective tax rate varies from the statutory rate for the three months ended September 30, 2005 due primarily to state taxes partially offset by tax benefits related to charitable contributions of inventory and tax-exempt interest income. The effective tax rate for the nine months ended September 30, 2005 varies from the statutory rate primarily due to tax benefits related to charitable contributions of inventory and tax-exempt interest income partially offset by state taxes.

12. Segment Information

The Company s business is classified into five reportable segments: branded pharmaceuticals, Meridian Medical Technologies (Meridian), royalties, contract manufacturing and all other. Branded pharmaceuticals includes a variety of branded prescription products that are separately categorized into four therapeutic areas: cardiovascular/metabolic, neuroscience, hospital/acute care, and other. These branded prescription products are aggregated because of the similarity in regulatory environment, manufacturing processes, methods of distribution, and types of customer. Meridian develops, manufactures, and sells to both commercial and government markets pharmaceutical products that are administered with an auto-injector. The principal source of revenues in the commercial market is the EpiPen® product, an epinephrine filled auto-injector which is primarily prescribed for the treatment of severe allergic reactions and which is primarily marketed, distributed and sold by Dey, L.P. Government revenues are principally derived from the sale of nerve agent antidotes and other emergency medicine auto-injector products marketed to the U.S. Department of Defense and other federal, state and local agencies, particularly those involved in homeland security, as well as to approved foreign governments. Contract manufacturing primarily includes pharmaceutical manufacturing services the Company provides to third-party pharmaceutical and biotechnology companies. Royalties include revenues the Company derives from pharmaceutical products after the Company has transferred the manufacturing or marketing rights to third parties in exchange for licensing fees or royalty payments.

The Company primarily evaluates its segments based on segment profit. Reportable segments were separately identified based on revenues, segment profit (excluding depreciation and amortization) and total assets. Revenues among the segments are presented in the individual segments and removed through eliminations in the information below. Substantially all of the eliminations relate to sales from the contract manufacturing segment to the branded pharmaceuticals segment. The Company s revenues are substantially all derived from activities within the United States and Puerto Rico. The Company s assets are substantially all located within the United States and Puerto Rico.

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The following represents selected information for the Company s reportable segments for the periods indicated:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Total revenues:				
Branded pharmaceuticals	$ 432,887	$ 454,548	$ 1,269,625	$ 1,176,627
Meridian Medical Technologies	37,125	38,366	132,292	96,998
Royalties	19,136	22,344	59,857	59,977
Contract manufacturing and other	137,979	229,112	409,170	478,323
Eliminations	(135,421)	(226,338)	(395,358)	(462,329)
Consolidated total net revenues	$ 491,706	$ 518,032	$ 1,475,586	$ 1,349,596
Segment profit:				
Branded pharmaceuticals	$ 349,662	$ 387,360	$ 1,045,306	$ 995,154
Meridian Medical Technologies	19,801	19,948	71,965	50,425
Royalties	16,799	20,194	52,594	53,140
Contract manufacturing and other	(1,029)	(1,727)	(204)	(4,800)
Other operating costs and expense	(262,048)	(238,428)	(809,244)	(766,184)
Other income (expense)	6,685	2,406	15,002	(5,642)
Income from continuing operations before tax	$ 129,870	$ 189,753	$ 375,419	$ 322,093

	As of September 30, 2006	As of December 31, 2005
Total assets:		
Branded pharmaceuticals	$ 2,908,521	$ 2,654,782
Meridian Medical Technologies	302,279	261,956
Royalties	20,117	20,444
Contract manufacturing and other	16,627	26,840
Other		1,220
Consolidated total assets	$ 3,247,544	$ 2,965,242

The following represents branded pharmaceutical revenues by therapeutic area:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Total revenues:				
Cardiovascular/metabolic	$ 198,962	$ 228,399	$ 603,968	$ 564,710
Neuroscience	124,592	135,515	365,875	333,021
Hospital/acute care	93,241	75,209	257,652	238,504
Other	16,092	15,425	42,130	40,392
Consolidated branded pharmaceutical revenues	$ 432,887	$ 454,548	$ 1,269,625	$ 1,176,627

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13. Restructuring Activities

During the third quarter of 2006, the Company decided to proceed with the implementation of steps under its plan to streamline manufacturing activities in order to improve operating efficiency and reduce costs, including the decision to transfer the production of Levoxyl® from its St. Petersburg, Florida facility to its Bristol, Tennessee facility by the end of 2008. As a result of these steps, the Company expects to incur restructuring charges of approximately $16,000 through the end of 2008, of which approximately $11,000 is associated with accelerated depreciation and approximately $5,000 is associated with employee termination costs.

During the fourth quarter of 2005, the Company made the decision to reduce its work force in order to improve efficiencies in operations. The Company had $1,509 accrued relating to these activities as of December 31, 2005.

A summary of the types of costs accrued and incurred are summarized below:

	Accrued Balance at December 31, 2005	Income Statement Impact	Payments	Non-Cash	Accrued Balance at June 30, 2006	Income Statement Impact	Payments	Non-Cash	Accrued Balance at September 30, 2006
Third quarter of 2006 action									
Employee separation payments	$	$	$	$	$	$ 3,202	$	$	$ 3,202
Accelerated depreciation[(1)]						1,472		(1,472)	
Fourth quarter of 2005 action									
Employee separation payments	1,509	(8)	(980)		521				521
	$ 1,509	$ (8)	$ (980)	$	$ 521	$ 4,674	$	$ (1,472)	$ 3,723

(1) Included in depreciation and amortization on the Condensed Consolidated Statement of Operations.

As of September 30, 2006, all accrued and expected restructuring charges relate to the Company s branded pharmaceutical segment. The accrued employee separation payments as of September 30, 2006 are expected to be paid by the end of 2008.

During 2005 the Company incurred restructuring charges as a result of the relocation of the Company s sales and marketing operations from Tennessee to New Jersey, and the decision to end principal operations of a small subsidiary of Meridian Medical Technologies located in Northern Ireland. As a result of these activities, the Company recorded charges of $597 and $2,603 in the third quarter and nine months ended September 30, 2005, respectively.

14. Investments in Debt Securities

The Company invests its excess cash in auction rate securities as part of its cash management strategy. Auction rate securities are long-term variable rate bonds tied to short-term interest rates that are reset through an auction process generally every seven to 35 days. As of the nine months ended September 30, 2006 and 2005, there were no cumulative gross unrealized gains or losses on investments in debt securities.

15. Marketable Securities

As of September 30, 2006 and December 31, 2005, the Company s investment in Palatin Technologies, Inc. common stock had a cost basis of $12,242 and there were cumulative unrealized holding gains of $1,266 and $6,260, respectively.

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During the third quarter of 2005, the Company sold its equity interest in Novavax, Inc. resulting in a gain on the sale of $1,040. During the first and second quarters of 2005, the Company incurred charges of $6,853 and $369, respectively, due to the determination that the decline in fair value of our equity interest in Novavax at March 31, 2005 and June 30, 2005 was other than temporary.

16. Change in Estimate

The Company s calculation of its product returns reserves is based on historical sales and return rates over the period during which customers have a right of return. The Company also considers current wholesale and retail inventory levels of the Company s products. Based on data received pursuant to the Company s inventory management agreements with its three key wholesale customers, there was a significant reduction of wholesale inventory levels of the Company s products during the first quarter of 2005. This reduction was primarily due to sales to retail outlets by the Company s wholesale customers, not returns of these products to the Company. This reduction resulted in a change in estimate during the first quarter of 2005 that decreased the Company s reserve for returns by approximately $20,000 and increased net sales from branded pharmaceuticals, excluding the adjustment to sales classified as discontinued operations, by the same amount. During the second quarter of 2005, the Company decreased its reserve for returns by approximately $5,000 and increased its net sales from branded pharmaceuticals, excluding the adjustment to sales classified as discontinued operations, by the same amount as a result of an additional reduction in wholesale inventory levels of the Company s branded products.

During the third quarter of 2005, the Company s actual returns of branded pharmaceutical products continued to decrease significantly compared to actual returns during the quarterly periods in 2004 and the first quarter of 2005. Additionally, based on data received pursuant to the Company s inventory management agreements with its key wholesale customers, the Company continued to experience normalized wholesale inventory levels of its branded pharmaceutical products during the third quarter of 2005. Accordingly, the Company believed that the rate of returns experienced during the second and third quarters of 2005 was more indicative of what it should expect in future quarters and adjusted its returns reserve accordingly. This change in estimate resulted in a decrease of approximately $15,000 in the returns reserve in the third quarter of 2005 and a corresponding increase in net sales from branded pharmaceutical products, excluding the adjustment to sales classified as discontinued operations. As a result of this increase in net sales, the co-promotion expense related to net sales of Altace® in the third quarter of 2005 increased by approximately $5,000. The effect of the change in estimate on the third quarter 2005 operating income was, therefore, approximately $10,000.

As a result of the Company s previously disclosed determination that it underpaid amounts due to Medicaid and other government pricing programs from 1998 through 2002, as further discussed in Note 9, the Company refined the calculation to compute the Average Manufacturer s Price (AMP) and Best Price in compliance with federal laws and regulations. During the third quarter of 2005, the Company began reporting to the Centers for Medicare and Medicaid Services using the refined calculation for computing AMP and Best Price. In addition, during the third quarter of 2005, the Company recalculated rebates due with respect to prior quarters utilizing the refined AMP and Best Price calculations. As a result of this updated information, during the third quarter of 2005, the Company decreased its reserve for estimated Medicaid and other government pricing program obligations and increased net sales from branded pharmaceutical products by approximately $21,000, approximately $13,000 of which related to the first and second quarters of 2005 and the balance of which related to prior periods. This does not include the adjustment to sales classified as discontinued operations. As a result of this increase in net sales, the co-promotion expense related to

net sales of Altace® in the third quarter of 2005 increased by approximately $6,000, approximately $2,000 of which related to the first and second quarters of 2005 and the balance of which related to prior periods. The effect of the change in estimate on the third quarter 2005 operating income was, therefore, approximately $15,000, approximately $11,000 of which related to the first and second quarters of 2005 and the balance of which related to prior periods.

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KING PHARMACEUTICALS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

As a result of actual returns during the first quarter of 2006, the estimated rate of returns used in the calculation of the Company s returns reserve for some of the Company s products continued to decrease. During the first quarter of 2006, the Company decreased its reserve for returns by approximately $8,000 and increased its net sales from branded pharmaceuticals, excluding the adjustment to sales classified as discontinued operations, by the same amount. As a result of this increase in net sales, the co-promotion expense related to net sales of Altace® in the first quarter of 2006 increased by approximately $1,000 and royalty expense related to net sales of Skelaxin® increased by approximately $1,000. The effect of the change in estimate on first quarter 2006 operating income was, therefore, approximately $6,000.

During the third quarter of 2006, the Company reduced its rebate expense and increased net sales from branded pharmaceutical products by approximately $9,300 due to the determination that a liability established in 2005 for a government pricing program for military dependents and retirees was no longer probable.

17. Discontinued Operations

On March 30, 2004, the Company s Board of Directors approved management s decision to market for divestiture some of the Company s women s health products. On November 22, 2004, the Company sold all of its rights in Prefest® for approximately $15,000. On December 23, 2004, the Company sold all of its rights in Nordette® for approximately $12,000.

The Prefest® and Nordette® product rights, which the Company divested on November 22, 2004 and December 23, 2004, respectively, had identifiable cash flows that were largely independent of the cash flows of other groups of assets and liabilities and are classified as discontinued operations in the accompanying financial statements. Prefest® and Nordette® were formerly included in the Company s branded pharmaceuticals segment.

Summarized financial information for the discontinued operations is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Total revenues	$ 865	$ (1,228)	$ 772	$ 2,606
Operating income (loss)	865	(1,226)	775	2,607
Net income (loss)	$ 555	$ (787)	$ 497	$ 1,618

Results of discontinued operations during 2006 and 2005 are primarily due to changes in estimated reserves for returns and rebates.

18. Guarantor Financial Statements

Each of the Company s subsidiaries, except Monarch Pharmaceuticals Ireland Limited (the Guarantor Subsidiaries), has guaranteed, on a full, unconditional and joint and several basis, the Company s performance under the $345,000 aggregate principal amount of the Debentures, of which $4,257 remain outstanding as of September 30, 2006, under

the $400,000 aggregate principal amount of the Notes, and under the $400,000 Senior Secured Revolving Credit Facility on a joint and several basis. There are no restrictions under the Company s financing arrangements on the ability of the Guarantor Subsidiaries to distribute funds to the Company in the form of cash dividends, loans or advances. The following combined financial data provides information regarding the financial position, results of operations and cash flows of the Guarantor Subsidiaries (condensed consolidating financial data). Separate financial statements and other disclosures concerning the Guarantor Subsidiaries are not presented because management has determined that such information would not be material to the holders of the debt.

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KING PHARMACEUTICALS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
GUARANTOR SUBSIDIARIES

CONDENSED CONSOLIDATING BALANCE SHEETS
(In thousands)
(Unaudited)

	September 30, 2006					December 31, 2005			
	King	Guarantor Subsidiaries	Non Guarantor Subsidiaries	Eliminating Entries	King Consolidated	King	Guarantor Subsidiaries	Non Guarantor Subsidiaries	Elimina Entri
ASSETS									
	$ 123,119	$ 11,489	$ 3,446	$	$ 138,054	$ 26,802	$ 1,071	$ 2,141	$
	779,545				779,545	494,663			
						130,400			
	98	254,161	1,487		255,746	1,221	221,854	506	
	148,558	37,899	313		186,770	195,421	31,877	765	
	10,214	58,939			69,153	21,524	60,253		
	99,306	3,050			102,356	50,724	8,566	1	
	1,160,840	365,538	5,246		1,531,624	920,755	323,621	3,413	
	110,033	193,789			303,822	108,712	193,762		
		921,802	3,026		924,828	44	963,944	3,206	
		121,152			121,152		121,152		
	13,508				13,508	18,502			
	(28,147)	285,538	1,107		258,498	(9,483)	239,452	1,063	
	38,911	55,201			94,112	30,225	46,874		
	2,565,693			(2,565,693)		2,299,835			(2,299
	$ 3,860,838	$ 1,943,020	$ 9,379	$ (2,565,693)	$ 3,247,544	$ 3,368,590	$ 1,888,805	$ 7,682	$ (2,299
LIABILITIES AND SHAREHOLDERS EQUITY									

$ 50,977	$ 29,737	$ 96	$	$ 80,810	$ 60,700	$ 23,762	$ 77	$	
82,850	388,844	1		471,695	151,125	368,491	4		
17,134	3,604	(121)		20,617	24,123	(1,701)	(121)		
4,257				4,257	345,000				
155,218	422,185	(24)		577,379	580,948	390,552	(40)		
400,000				400,000					
17,280	6,614			23,894	17,371	2,989			
1,042,069	(1,054,542)	12,473			796,849	(808,256)	11,407		
1,614,567	(625,743)	12,449		1,001,273	1,395,168	(414,715)	11,367		
2,246,271	2,568,763	(3,070)	(2,565,693)	2,246,271	1,973,422	2,303,520	(3,685)		(2,299
$ 3,860,838	$ 1,943,020	$ 9,379	$ (2,565,693)	$ 3,247,544	$ 3,368,590	$ 1,888,805	$ 7,682	$	(2,299

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KING PHARMACEUTICALS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
GUARANTOR SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands)
(Unaudited)

	Three Months Ended September 30, 2006					Three Months Ended September 30, 200			
	King	Guarantor Subsidiaries	Non Guarantor Subsidiaries	Eliminations	King Consolidated	King	Guarantor Subsidiaries	Non Guarantor Subsidiaries	Eliminations
	$ 106,996	$ 472,276	$ (157)	$ (106,545)	$ 472,570	$ 200,301	$ 495,280	$ 221	$ (200,114)
ue		19,136			19,136		22,344		
	106,996	491,412	(157)	(106,545)	491,706	200,301	517,624	221	(200,114)
s and									
es	36,358	176,660		(106,545)	106,473	34,162	258,087	122	(200,114)
l and	57,653	99,883	58		157,594	59,403	121,027	1,554	
ion costs						466			
	181	63,238			63,419	174	23,875		
nd	5,395	32,378	60		37,833	3,959	27,226	167	
charges	202	3,000			3,202		597		
f products							(20)		
g costs and	99,789	375,159	118	(106,545)	368,521	98,164	430,792	1,843	(200,114)
me (loss)	7,207	116,253	(275)		123,185	102,137	86,832	(1,622)	
expense):									
e	8,434	53	2		8,489	5,244	9		
e	(1,881)	(13)			(1,894)	(3,105)	(31)		
ment						1,040			
t of debt	(11)				(11)				
	5	68	28		101	(312)	(425)	(14)	
ngs of	100,267			(100,267)		69,255			(69,255)

nterest me	(10,533)	10,646	(113)			(18,952)	19,122	(170)	
ome	96,281	10,754	(83)	(100,267)	6,685	53,170	18,675	(184)	(69,255)
rom rations taxes	103,488	127,007	(358)	(100,267)	129,870	155,307	105,507	(1,806)	(69,255)
pense	13,083	27,106	(169)		40,020	33,450	34,291	(632)	
rom rations	90,405	99,901	(189)	(100,267)	89,850	121,857	71,216	(1,174)	(69,255)
perations: rom perations		865			865		(1,226)		
pense		310			310		(439)		
loss) from perations,		555			555		(787)		
ss)	$ 90,405	$ 100,456	$ (189)	$ (100,267)	$ 90,405	$ 121,857	$ 70,429	$ (1,174)	$ (69,255)

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KING PHARMACEUTICALS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
GUARANTOR SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands)
(Unaudited)

	Nine Months Ended September 30, 2006					Nine Months Ended September 30, 2			
	King	Guarantor Subsidiaries	Non Guarantor Subsidiaries	Eliminations	King Consolidated	King	Guarantor Subsidiaries	Non Guarantor Subsidiaries	Eliminatio
	$ 317,821	$ 1,413,603 59,857	$ 1,254	$ (316,949)	$ 1,415,729 59,857	$ 396,709	$ 1,287,531 59,977	$ 805	$ (395,42
	317,821	1,473,460	1,254	(316,949)	1,475,586	396,709	1,347,508	805	(395,42
d									
	119,801	502,262	811	(316,949)	305,925	106,187	544,478	438	(395,42
d	160,528	322,274	(707)		482,095	151,341	315,477	1,681	
costs						3,898			
	3,102	209,829			212,931	466	52,555		
	16,164	94,401	180		110,745	11,768	100,431	499	
ges	202	279 2,992			279 3,194	322	126,923 2,281		
ducts							(1,458)		
ts and	299,797	1,132,037	284	(316,949)	1,115,169	273,982	1,140,687	2,618	(395,42
loss)	18,024	341,423	970		360,417	122,727	206,821	(1,813)	
ense):	22,650	190	2		22,842	10,966	497		
	(7,769)	(156)			(7,925)	(8,827)	(49)		
						(6,182)			
debt	698				698				
	(225)	(711)	323		(613)	(494)	(1,178)	(375)	

of									
	266,175			(266,175)		172,344			(172,34
est									
	(36,226)	36,643	(417)			(47,942)	48,412	(470)	
	245,303	35,966	(92)	(266,175)	15,002	119,865	47,682	(845)	(172,34
ons									
s	263,327	377,389	878	(266,175)	375,419	242,592	254,503	(2,658)	(172,34
e									
	11,342	112,325	264		123,931	30,183	82,049	(930)	
ons	251,985	265,064	614	(266,175)	251,488	212,409	172,454	(1,728)	(172,34
tions:									
tions		775			775		2,607		
e		278			278		989		
tions		497			497		1,618		
	$ 251,985	$ 265,561	$ 614	$ (266,175)	$ 251,985	$ 212,409	$ 174,072	$ (1,728)	$ (172,34

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KING PHARMACEUTICALS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
GUARANTOR SUBSIDIARIES

CONDENSED CONSOLIDATING STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Nine Months Ended September 30, 2006				Nine Months Ended September 30, 2005			
	King	Guarantor Subsidiaries	Non Guarantor Subsidiaries	King Consolidated	King	Guarantor Subsidiaries	Non Guarantor Subsidiaries	King Consolidate
ash flows (used in) ovided by perating activities	$ (39,643)	$ 336,660	$ 240	$ 297,257	$ 122,662	$ 282,310	$ (149)	$ 404,823
ash flows from vesting activities: ransfers from (to) stricted cash	128,722			128,722	(75,126)	1,582		(73,544
urchases of vestments in debt curities	(1,170,272)			(1,170,272)	(879,379)			(879,379
roceeds from aturities and sales investments in ebt securities	885,390			885,390	470,872			470,872
urchases of operty, plant and uipment	(17,512)	(13,708)		(31,220)	(6,941)	(25,393)		(32,334
roceeds from sale of operty and uipment					1			1
urchases of product ghts		(24,886)		(24,886)				
rrow International mited collaboration		(35,000)		(35,000)				
roceeds from sale of arketable securities					6,453			6,453
alatin collaboration					(10,000)			(10,000
et cash used in vesting activities	(173,672)	(73,594)		(247,266)	(494,120)	(23,811)		(517,931

ash flows from nancing activities: roceeds from ercise of stock ptions, net	6,844			6,844	682			682
xcess tax benefit om stock-based mpensation	425			425				
roceeds from suance of long-term ebt	400,000			400,000				
ayments on ng-term debt	(338,434)			(338,434)				
ebt issuance costs	(10,786)			(10,786)				
tercompany	251,583	(252,648)	1,065		284,575	(285,717)	1,142	
et cash provided by sed in) financing tivities	309,632	(252,648)	1,065	58,049	285,257	(285,717)	1,142	682
crease (decrease) in sh and cash uivalents	96,317	10,418	1,305	108,040	(86,201)	(27,218)	993	(112,426
ash and cash uivalents, ginning of period	26,802	1,071	2,141	30,014	164,451	27,035	1,170	192,656
ash and cash uivalents, end of riod	$ 123,119	$ 11,489	$ 3,446	$ 138,054	$ 78,250	$ (183)	$ 2,163	$ 80,230

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

The following discussion contains certain forward-looking statements that reflect management s current views of future events and operations. This discussion should be read in conjunction with the following: (a) Risk Factors set out below and in our Annual Report on Form 10-K for the year ended December 31, 2005, which are supplemented by the discussion which follows; (b) our audited consolidated financial statements and related notes which are included in our Annual Report on Form 10-K for the year ended December 31, 2005; and (c) our unaudited consolidated financial statements and related notes which are included in this report on Form 10-Q. Please see the sections entitled Risk Factors and A Warning About Forward-Looking Statements for a discussion of the uncertainties, risks and assumptions associated with these statements.

OVERVIEW

Our Business

We are a vertically integrated pharmaceutical company that develops, manufactures, markets and sells branded prescription pharmaceutical products. To capitalize on opportunities in the pharmaceutical industry, we seek to develop, in-license, acquire or obtain commercialization rights to novel branded prescription pharmaceutical products in attractive markets.

Our corporate strategy is focused on three key therapeutic areas: cardiovascular/metabolic, neuroscience, and hospital/acute care products. We believe each of our key therapeutic areas has significant market potential and our organization is aligned accordingly. We work to achieve organic growth by maximizing the potential of our currently marketed products through sales and marketing and product life-cycle management. We also work to achieve organic growth through the successful development of new branded pharmaceutical products. Additionally, we seek to achieve growth through the acquisition or in-licensing of novel branded pharmaceutical products in later stages of development and technologies that have significant market potential that complement our three key therapeutic areas. We may also seek company acquisitions which add products or products in development, technologies or sales and marketing capabilities to our key therapeutic areas or that otherwise complement our operations.

Utilizing our internal resources and a disciplined business development process, we strive to be a leader and partner of choice in bringing innovative, clinically-differentiated therapies and technologies to market in our key therapeutic areas.

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RESULTS OF OPERATIONS

Three and Nine Months Ended September 30, 2006 and 2005

The following table summarizes total revenues and cost of revenues by operating segment, excluding intercompany transactions:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2006	2005	2006	2005
	(In thousands)		(In thousands)	
Total Revenues				
Branded pharmaceuticals	$ 432,887	$ 454,548	$ 1,269,625	$ 1,176,627
Meridian Medical Technologies	37,125	38,366	132,292	96,998
Royalties	19,136	22,344	59,857	59,977
Contract manufacturing and other	2,558	2,774	13,812	15,994
Total revenues	$ 491,706	$ 518,032	$ 1,475,586	$ 1,349,596
Cost of Revenues				
Branded pharmaceuticals	$ 83,225	$ 67,188	$ 224,319	$ 181,473
Meridian Medical Technologies	17,324	18,418	60,327	46,573
Royalties	2,337	2,150	7,263	6,837
Contract manufacturing and other	3,587	4,501	14,016	20,794
Total cost of revenues	$ 106,473	$ 92,257	$ 305,925	$ 255,677
Gross Profit				
Branded pharmaceuticals	$ 349,662	$ 387,360	$ 1,045,306	$ 995,154
Meridian Medical Technologies	19,801	19,948	71,965	50,425
Royalties	16,799	20,194	52,594	53,140
Contract manufacturing and other	(1,029)	(1,727)	(204)	(4,800)
Total gross profit	$ 385,233	$ 425,775	$ 1,169,661	$ 1,093,919

The following table summarizes our gross to net sales deductions:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2006	2005	2006	2005
	(In thousands)		(In thousands)	
Gross Sales	$ 607,543	$ 633,562	$ 1,831,972	$ 1,697,919
Commercial Rebates	47,306	63,733	144,350	145,248
Medicaid Rebates	2,882	4,143	21,194	59,947
Medicare Part D Rebates	15,586		41,456	
Chargebacks	24,193	31,291	76,440	71,028

Returns	2,511	(2,971)	10,053	2,758
Trade Discounts/Other	22,494	20,562	62,121	66,736
	492,571	516,804	1,476,358	1,352,202
Discontinued Operations	865	(1,228)	772	2,606
Net Sales	$ 491,706	$ 518,032	$ 1,475,586	$ 1,349,596

Gross sales were lower in the third quarter of 2006 compared to the third quarter of 2005 primarily due to an increase in wholesale inventory levels of certain of our branded pharmaceutical products in the third quarter of 2005 which benefited gross sales during that quarter. Additionally, the lower level of gross sales during the third quarter of 2006 was also due to a decline in prescriptions of certain of our branded

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pharmaceutical products since the third quarter of 2005, partially offset by the effect of price increases taken during the fourth quarter of 2005. Gross sales were higher in the first nine months of 2006 compared to the first nine months of 2005 primarily due to price increases, higher unit sales as a result of the effect of wholesale inventory reductions of some of our branded pharmaceutical products during 2005, particularly Altace®, and an increase in gross sales of Meridian Medical Technologies, partially offset by a decline in prescriptions of certain of our branded pharmaceutical products during 2006.

The following tables provide the activity and ending balances for our significant gross to net sales categories:

Accrual for Rebates, including Administrative Fees (in thousands):

	2006	2005
Balance at January 1, net of prepaid amounts	$ 126,240	$ 179,062
Current provision related to sales made in current period	79,690	62,504
Current provision related to sales made in prior periods	(3,532)	(7,481)
Rebates paid	(115,999)	(83,196)
Balance at March 31, net of prepaid amounts	$ 86,399	$ 150,889
Current provision related to sales made in current period	69,912	79,696
Current provision related to sales made in prior periods	(4,844)	2,600
Rebates paid	(82,158)	(80,423)
Balance at June 30, net of prepaid amounts	$ 69,309	$ 152,762
Current provision related to sales made in current period	76,684	92,178
Current provision related to sales made in prior periods	(10,910)	(24,302)
Rebates paid	(76,460)	(76,579)
Balance at September 30, net of prepaid amounts	$ 58,623	$ 144,059

Medicaid rebate expense was lower in the third quarter of 2006 than in the third quarter of 2005 and was lower in the first nine months of 2006 than in the first nine months of 2005, primarily due to the Government shifting persons who were covered by the Medicaid Program to the Medicare Part D Program. During January 2006, the Medicare Prescription Drug Improvement and Modernization Act became effective. This law provides outpatient prescription drug coverage to senior citizens and certain disabled citizens in the United States. We have contracts with organizations that administer the Medicare Part D Program, which require us to pay rebates based on contractual pricing and actual utilization under the plans.

As previously disclosed, during the third quarter of 2005, we began reporting to the Centers for Medicare and Medicaid Services using a refined calculation to compute our Average Manufacturer s Price (AMP) and Best Price. In addition, during the third quarter of 2005, we recalculated rebates due with respect to prior quarters utilizing the refined AMP and Best Price Calculations. As a result of this updated information, during the third quarter of 2005, we decreased our reserve for estimated Medicaid and other government pricing program obligations and increased net sales from branded pharmaceutical products by approximately $21.0 million, approximately $13.0 million of which related to the first and second quarters of 2005 and the balance of which related to prior periods.

During the third quarter of 2006, we reduced our rebate expense and increased net sales from branded pharmaceutical products by approximately $9.3 million due to the determination that a liability established in 2005 for a government pricing program for military dependents and retirees was no longer probable.

During the first quarter of 2006, we paid approximately $129.3 million related to (i) the settlement agreements with the Office of Inspector General of the United States Department of Health and Human Services (HHS/OIG) and the Department of Veterans Affairs, to resolve the governmental investigations related to our underpayment of rebates owed to Medicaid and other governmental pricing programs during the

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period from 1994 to 2002 and (ii) similar state settlement agreements. For a discussion regarding this settlement, please see Settlement of Governmental Pricing Investigation included in Note 9, Contingencies, in Item 1, Financial Statements. Of the $129.3 million paid in the first quarter of 2006, approximately $64.0 million reduced the rebate accrual and is reflected in Rebates paid in the table above.

In addition, during the first quarter of 2006, we delayed normal Medicaid rebate payments as a result of prior overpayments. During the second quarter of 2006, we began reducing our payments for Medicaid rebates to utilize overpayments made to the government related to Medicaid during the government pricing investigation in 2003, 2004 and 2005. During the period of the investigation, we made actual Medicaid payments in excess of estimated expense to avoid any underpayments to the government. As a result of refining the AMP and Best Price calculations in the third quarter of 2005, we discontinued the practice of making payments in excess of the amounts expensed. We expect to recover the remaining overpayments to the government and will continue to reduce cash payments in the future until this overpayment is fully recovered. For a discussion regarding this investigation, please see Settlement of Government Pricing Investigation included in Note 9, Contingencies , in Item 1, Financial Statements. In the third quarter and the nine months ended September 30, 2006, the utilization of overpayments reduced our rebate payments by approximately $3.4 million and $23.2 million, respectively, and has therefore reduced Rebates Paid in the table above.

Accrual for Returns (in thousands):

	2006	2005
Balance at January 1	$ 50,902	$ 122,863
Current provision	(702)	(4,438)
Actual returns	(7,692)	(45,394)
Ending balance at March 31	$ 42,508	$ 73,031
Current provision	8,244	10,167
Actual returns	(4,410)	(15,009)
Ending balance at June 30	$ 46,342	$ 68,189
Current provision	2,511	(2,971)
Actual returns	(6,760)	(10,335)
Ending balance at September 30	$ 42,093	$ 54,883

Our calculation for returns reserves is based on historical sales and return rates over the period during which customers have a right of return. We also consider current wholesale and retail inventory levels of our products. Based on data received from our inventory management agreements with our three key wholesale customers, there was a significant reduction of wholesale inventory levels of our products during the first quarter of 2005. This reduction resulted in a change in estimate during the first quarter of 2005 that decreased the reserve for returns by approximately $20.0 million and increased net sales from branded pharmaceuticals, excluding the adjustment to sales classified as discontinued operations, by the same amount. During the second quarter of 2005, we decreased our reserve for returns by approximately $5.0 million and increased our net sales from branded pharmaceuticals, excluding the adjustment for sales classified as discontinued operations, by the same amount as a result of an additional reduction in wholesale

inventory levels of our branded products. The Accrual for Returns, in the table above reflects these adjustments as a reduction in the current provision.

During the third quarter of 2005, our actual returns of branded pharmaceutical products continued to decrease significantly compared to actual returns during the quarterly periods in 2004 and the first quarter of 2005. Additionally, based on data received pursuant to the our inventory management agreements with our key wholesale customers, we continued to experience normalized wholesale inventory levels of our branded pharmaceutical products during the third quarter of 2005. Accordingly, we believed that the rate of returns experienced during the second and third quarters of 2005 was more indicative of what we expected in future quarters and adjusted our returns reserve accordingly. This change in estimate resulted in a decrease of

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approximately $15.0 million in the returns reserve in the third quarter of 2005 and a corresponding increase in net sales from branded pharmaceutical products. As a result of this increase in net sales, the co-promotion expense related to net sales of Altace® increased by approximately $5.0 million. The effect of the change in estimate on operating income was, therefore, approximately $10.0 million.

As a result of the actual returns during the first quarter of 2006, the estimated rate of returns used in the calculation of our returns reserve for some of our products continued to decrease. During the first quarter of 2006, we decreased our reserve for returns by approximately $8.0 million and increased our net sales from branded pharmaceuticals, excluding the adjustment to sales classified as discontinued operations, by the same amount. The Accrual for Returns table above reflects this adjustment as a reduction in the current provision. As a result of this increase in net sales, the co-promotion expense related to net sales of Altace® in the first quarter of 2006 increased by approximately $1.0 million and royalty expense related to net sales of Skelaxin® increased by approximately $1.0 million. The effect of the change in estimate on first quarter 2006 operating income was, therefore, approximately $6.0 million.

Accrual for Chargebacks (in thousands):

	2006	2005
Balance at January 1	$ 13,153	$ 27,953
Current provision	29,390	18,558
Actual chargebacks	(25,972)	(22,048)
Ending balance at March 31	$ 16,571	$ 24,463
Current provision	22,857	21,179
Actual chargebacks	(25,402)	(31,741)
Ending balance at June 30	$ 14,026	$ 13,901
Current provision	24,193	31,291
Actual chargebacks	(25,278)	(30,518)
Ending balance at September 30	$ 12,941	$ 14,674

Branded Pharmaceuticals

	For the Three Months Ended September 30,		Change 2006 vs. 2005		For the Nine Months Ended September 30,		Change 2006 vs. 2005	
	2006	2005	$	%	2006	2005	$	%
	(In thousands)				(In thousands)			
Branded Pharmaceutical revenue:								
Altace®	$ 158,914	$ 174,200	$ (15,286)	(8.8)%	$ 471,604	$ 404,103	$ 67,501	16.7%
Skelaxin®	105,933	115,893	(9,960)	(8.6)	302,037	274,619	27,418	10.0

Thrombin-JMI®	70,029	53,767	16,262	30.2	190,133	169,959	20,174	11.9
Levoxyl®	24,644	36,080	(11,436)	(31.7)	84,726	117,373	(32,647)	(27.8)
Sonata®	18,660	19,622	(962)	(4.9)	63,838	58,402	5,436	9.3
Other	54,707	54,986	(279)	(1.0)	157,287	152,171	5,116	3.4
Total revenue	432,887	454,548	(21,661)	(4.8)	1,269,625	1,176,627	92,998	7.9
Cost of Revenues	83,225	67,188	16,037	23.9	224,319	181,473	42,846	23.6
Gross Profit	$ 349,662	$ 387,360	$ (37,698)	(9.7)%	$ 1,045,306	$ 995,154	$ 50,152	5.0%
Gross Profit Percent	80.8%	85.2%			82.3%	84.6%		

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Net sales from branded pharmaceutical products were lower in the third quarter of 2006 than in the third quarter of 2005 primarily due to an increase in wholesale inventory levels of certain of our branded pharmaceutical products in the third quarter of 2005 and the effect of a reduction in reserves for returns and rebates during the third quarter of 2005 as discussed above, each of which benefited net sales in the third quarter of 2005. The lower level of net sales in the third quarter of 2006 was also due to a decline in prescriptions of certain of our branded pharmaceutical products since the third quarter of 2005, partially offset by the effect of price increases taken during the fourth quarter of 2005 and a reduction in the rebate reserve for a government pricing program for military dependants and retirees during 2006 as discussed above. Based on inventory data provided to us by our key customers, we believe that wholesale inventory levels of our key products, Altace®, Skelaxin®, Thrombin-JMI®, Levoxyl®, and Sonata®, as of September 30, 2006, are at or below normalized levels. We estimate that wholesale and retail inventories of our products as of September 30, 2006 represent gross sales of approximately $155.0 million to $165.0 million. For a discussion regarding the potential risk of generic competition for Altace®, Skelaxin®, and Sonata®, please see Other Legal Proceedings included in Note 9, Contingencies, in Item 1, Financial Statements.

Sales of Key Products

Altace®

Net sales of Altace® were lower in the third quarter of 2006 than in the third quarter of 2005 primarily due to an increase in wholesale inventory levels during the third quarter of 2005, and the effect of a reduction in reserves for returns and rebates during the third quarter of 2005 as discussed above, each of which benefited net sales of this product in the third quarter of 2005. Net sales of Altace® during the third quarter of 2006 did benefit from a price increase taken in the fourth quarter of 2005, a reduction in commercial rebates in the third quarter of 2006 compared to the third quarter of 2005, and a reduction in the rebate reserve for a government pricing program for military dependants and retirees during the third quarter of 2006 as discussed above. Total prescriptions for Altace® decreased approximately 2.6% in the third quarter of 2006 from the third quarter of 2005 according to IMS America, Ltd. (IMS) monthly prescription data.

Net sales of Altace® were higher in the first nine months of 2006 than in the first nine months of 2005 primarily due to a price increase taken in the fourth quarter of 2005 and higher unit sales in 2006 as a result of the effects of wholesale inventory reductions of Altace® in 2005, partially offset by the effect of a reduction in reserves for returns and rebates during the third quarter of 2005 as discussed above. We do not believe Altace® net sales will continue to increase at the rate experienced in the first nine months of 2006.

For a discussion regarding the risk of potential generic competition for Altace®, please see Other Legal Proceedings included in Note 9, Contingencies, in Item 1, Financial Statements.

Skelaxin®

Net sales of Skelaxin® decreased in the third quarter of 2006 from the third quarter of 2005 primarily due to an increase in wholesale inventory levels during the third quarter of 2005 and the effect of a reduction in reserves for returns and rebates during the third quarter of 2005 as discussed above, each of which benefited net sales of this product in the third quarter of 2005. Net sales of Skelaxin® in the third quarter of 2006 did benefit from a reduction in government rebates in the third quarter of 2006 compared to the third quarter of 2005, a price increase taken in the fourth quarter of 2005 and a reduction in the rebate reserve for a government pricing program for military dependants and retirees during the third quarter of 2006 as discussed above. Total prescriptions for Skelaxin® increased approximately 0.1% in the third quarter of 2006 from the third quarter of 2005 according to IMS monthly prescription data.

Net sales of Skelaxin® increased in the first nine months of 2006 from the first nine months of 2005 primarily due to a price increase taken in the fourth quarter of 2005 and a reduction in government rebates, partially offset by a decline in prescriptions in 2006, and the effect of a reduction in reserves for returns and rebates during the third quarter of 2005 as discussed above. Skelaxin® net sales may not continue to increase at the rate experienced in the first nine months of 2006.

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As previously disclosed, the patents associated with Skelaxin® are the subject of multiple challenges. Under the current circumstances, the continued exclusivity of Skelaxin® is unpredictable and we cannot be certain that the product will remain exclusive for any length of time. For a discussion regarding the risk of potential generic competition for Skelaxin®, please see the discussion under the heading Other Legal Proceedings included in Note 9, Contingencies, in Item 1, Financial Statements.

Thrombin-JMI®

Net sales of Thrombin-JMI® increased in the third quarter of 2006 compared to the third quarter of 2005 primarily due to an increase in wholesale inventory levels during the third quarter of 2006 and a price increase taken in the fourth quarter of 2005. We do not believe Thrombin-JMI® net sales will continue to increase at the rate experienced in the third quarter of 2006.

Net sales of Thrombin-JMI® increased in the first nine months of 2006 compared to the first nine months of 2005 primarily due to changes in wholesale inventory levels and a price increase taken in the second half of 2005, partially offset by an increase in chargebacks and commercial rebates during the first nine months of 2006 compared to the first nine months of 2005.

Levoxyl®

In 2004, the FDA approved certain other levothyroxine sodium products as bioequivalent and therapeutically equivalent to Levoxyl®. Since this time, Levoxyl® has competed in a highly genericized market.

Net sales of Levoxyl® decreased in the third quarter of 2006 from the third quarter of 2005 primarily due to a decline in prescriptions since the third quarter of 2005, the effect of a reduction in reserves for returns and rebates during the third quarter of 2005 as discussed above, and a higher rate of commercial and government rebates and chargebacks in the third quarter of 2006 compared to the third quarter of 2005, partially offset by a price increase taken in the fourth quarter of 2005. Total prescriptions for Levoxyl® were approximately 14.1% lower in the third quarter of 2006 than in the third quarter of 2005 according to IMS monthly prescription data. While prescriptions for this product may continue to decline, we believe the rate of any decline may be lower than that recently experienced.

Net sales of Levoxyl® decreased in the first nine months of 2006 from the first nine months of 2005 primarily due to a decrease in prescriptions in 2006, partially offset by price increases taken in the fourth quarter of 2005 and changes in wholesale inventory levels. During the first nine months of 2005, net sales of Levoxyl® benefited from the reduction in the reserve for returns described above and a reduction in the reserve for rebates. During the first nine months of 2006, net sales of Levoxyl® benefited from a favorable change in estimate during the first quarter of 2006 of approximately $7.0 million in the product s reserve for Medicaid rebates as a result of the government pricing investigation settlement. This benefit was substantially offset by increases in Medicaid rebate reserves for other products as a result of the settlement.

Sonata®

Net sales of Sonata® were lower in the third quarter of 2006 than in the third quarter of 2005 primarily due to a decline in prescriptions since the third quarter of 2005 and the effect of a reduction in reserves for returns and rebates during 2005, partially offset by a reduction in government and commercial rebates and price increases taken in the fourth quarter of 2005 and the third quarter of 2006. Total prescriptions for Sonata® decreased approximately 18.5% in the third quarter of 2006 from the third quarter of 2005 according to IMS monthly prescription data. The decrease in prescriptions during 2006 was primarily due to new competitors that entered the market in 2005. While prescriptions for this product may continue to decline, we believe the rate of any decline may be lower than that

recently experienced.

Net sales of Sonata® were higher in the first nine months of 2006 than in the first nine months of 2005 primarily due to higher unit sales as a result of wholesale inventory reductions of Sonata® in 2005 and price increases taken in the fourth quarter of 2005 and the third quarter of 2006, partially offset by a decrease in prescriptions during 2006.

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For a discussion regarding the risk of potential generic competition for Sonata®, please see Other Legal Proceedings included in Note 9, Contingencies, in Item 1, Financial Statements.

Other Branded Pharmaceutical Products

Net sales of other branded pharmaceutical products in the third quarter of 2006 were consistent with the third quarter of 2005 primarily due to decreases in unit sales that were generally offset by price increases. Most of these products are not promoted through our sales force and prescriptions for many of these products are declining. We do not believe net sales of other branded pharmaceutical products will grow from the level of net sales achieved in the third quarter of 2006 and may continue to decline.

Net sales of other branded pharmaceutical products were higher in the first nine months of 2006 compared to the first nine months of 2005 primarily due to the effects of wholesale inventory reductions in the first nine months of 2005 and price increases which were partially offset by decreases in prescriptions.

Cost of Revenues

Cost of revenues from branded pharmaceutical products increased in the third quarter of 2006 compared to the third quarter of 2005 primarily due to additional royalties we began paying on Skelaxin® on January 1, 2006. The royalties on Skelaxin® will increase in the fourth quarter of 2006 due to the achievement of a certain regulatory milestone by Mutual Pharmaceutical Company, Inc. (Mutual).

Cost of revenues from branded pharmaceutical products increased in the first nine months of 2006 compared to the first nine months of 2005 primarily due to the cost of revenues associated with higher unit sales of branded pharmaceutical products in the first nine months of 2006 and an increase in royalties associated with Skelaxin®.

Cost of revenues in the first nine months of 2005 includes the benefit of a special item in the amount of $1.6 million related to changes in estimates regarding the effect of some excess purchase commitments.

Special items are those particular material income or expense items that our management believes are not related to our ongoing, underlying business, are not recurring, or are not generally predictable. These items include, but are not limited to, merger and restructuring expenses; non-capitalized expenses associated with acquisitions, such as in-process research and development charges and one-time inventory valuation adjustment charges; charges resulting from the early extinguishments of debt; asset impairment charges; expenses of drug recalls; and gains and losses resulting from the divestiture of assets. We believe the identification of special items enhances an analysis of our ongoing, underlying business and an analysis of our financial results when comparing those results to that of a previous or subsequent like period. However, it should be noted that the determination of whether to classify an item as a special charge involves judgments by us.

Meridian Medical Technologies

	For the Three Months Ended September 30,		Change 2006 vs. 2005		For the Nine Months Ended September 30,		Change 2006 vs. 2005	
	2006	2005	$	%	2006	2005	$	%
	(In thousands)				(In thousands)			
Meridian Medical	$ 37,125	$ 38,366	$ (1,241)	(3.2)%	$ 132,292	$ 96,998	$ 35,294	36.4%

Technologies revenue								
Cost of Revenues	17,324	18,418	(1,094)	(5.9)	60,327	46,573	13,754	29.5
Gross Profit	$ 19,801	$ 19,948	$ (147)	<1.0%	$ 71,965	$ 50,425	$ 21,540	42.7%
Gross Profit Percent	53.3%	52.0%			54.4%	52.0%		

Revenues from Meridian Medical Technologies decreased in the third quarter of 2006 compared to the third quarter of 2005 primarily due to decreases in unit sales of our auto-injector products, partially offset by revenues derived from our acquisition of the rights to market and sell Epipen® in Canada that we purchased from Allerex Laboratory LTD on March 1, 2006. Most of our Epipen® sales are based on our supply agreement with Dey, L.P., which markets, distributes and sells the product. Revenues from Meridian Medical

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Technologies fluctuate based on buying patterns of Dey, L.P. and the government. Total prescriptions for Epipen® in the United States increased approximately 2.9% in the third quarter of 2006 from the third quarter of 2005 according to IMS monthly prescription data. We believe net sales in the fourth quarter of 2006 will be lower than the level experienced in the third quarter of 2006.

Revenues from Meridian Medical Technologies increased in the first nine months of 2006 compared to the first nine months of 2005 primarily due to increases in unit sales of our auto-injector products, as well as revenues derived from our acquisition of the rights to market and sell EpiPen® in Canada.

Cost of revenues from Meridian Medical Technologies decreased in the third quarter of 2006 compared to the third quarter of 2005 primarily due to a decrease in unit sales. Cost of revenues from Meridian Medical Technologies increased in the first nine months of 2006 compared to the first nine months of 2005 primarily due to higher unit sales.

Royalties

	For the Three Months Ended September 30,		Change 2006 vs. 2005		For the Nine Months Ended September 30,		2006 vs. 2005 Change	
	2006	2005	$	%	2006	2005	$	%
	(In thousands)				(In thousands)			
Royalty revenue	$ 19,136	$ 22,344	$ (3,208)	(14.4)%	$ 59,857	$ 59,977	$ (120)	<1.0%
Cost of Revenues	2,337	2,150	187	8.7	7,263	6,837	426	6.2
Gross Profit	$ 16,799	$ 20,194	$ (3,395)	(16.8)%	$ 52,594	$ 53,140	$ (546)	(1.0)%
Gross Profit Percent	87.8%	90.4%			87.9%	88.6%		

Revenues from royalties are derived primarily from payments we receive based on sales of Adenoscan®. We are not responsible for the marketing of this product and, thus, are not able to predict whether revenue from royalties will increase or decrease in 2006. For a discussion regarding the potential risk of generic competition for Adenoscan®, please see Other Legal Proceedings included in Note 9 Contingencies in Item 1, Financial Statements.

Contract Manufacturing and Other

	For the Three Months Ended September 30,		Change 2006 vs. 2005		For the Nine Months Ended September 30,		Change 2006 vs. 2005	
	2006	2005	$	%	2006	2005	$	%
	(In thousands)				(In thousands)			
Contract manufacturing revenue	$ 2,558	$ 2,774	$ (216)	(7.8)%	$ 13,812	$ 15,994	$ (2,182)	(13.6)%
Cost of Revenues	3,587	4,501	(914)	(20.3)	14,016	20,794	(6,778)	(32.6)

Gross Profit	$ (1,029)	$ (1,727)	$ 698	40.4%	$ (204)	$ (4,800)	$ 4,596	95.8%

Revenues from contract manufacturing decreased in the first nine months of 2006 compared to the first nine months of 2005 due to a lower volume of units manufactured for third parties. This decline may continue in future periods.

Cost of sales associated with contract manufacturing decreased in the first nine months of 2006 from the first nine months of 2005 primarily due to decreased unit production of products we manufacture for third parties.

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Operating Costs and Expenses

	For the Three Months Ended September 30,		Change 2006 vs. 2005		For the Nine Months Ended September 30,		Change 2006 vs. 2005	
	2006	2005	$	%	2006	2005	$	%
	(In thousands)				(In thousands)			
tal gross profit	$ 385,233	$ 425,775	$ (40,542)	(9.5)%	$ 1,169,661	$ 1,093,919	$ 75,742	6.9
lling, general and ministrative	157,594	182,450	(24,856)	(13.6)	482,095	472,397	9,698	2.1
search and velopment	63,419	24,049	39,370	>100.0	212,931	53,021	159,910	>100.0
preciation and ortization	37,833	31,352	6,481	20.7	110,745	112,698	(1,953)	(1.7
angible asset pairment					279	126,923	(126,644)	(99.8
structuring charges	3,202	597	2,605	>100.0	3,194	2,603	591	22.7
in on sale of oducts		(20)	20	100.00		(1,458)	1,458	100.0
erating income	$ 123,185	$ 187,347	$ (64,162)	(34.2)%	$ 360,417	$ 327,735	$ 32,682	10.0

Selling, General and Administrative Expenses

	For the Three Months Ended September 30,		Change 2006 vs. 2005		For the Nine Months Ended September 30,		Change 2006 vs. 2005	
	2006	2005	$	%	2006	2005	$	%
	(In thousands)				(In thousands)			
Selling, general and administrative, exclusive of co-promotion fees and Mylan transaction costs	$ 107,300	$ 111,638	$ (4,338)	(3.9)%	$ 319,480	$ 305,911	$ 13,569	4.4%
Mylan transaction costs		466	(466)	(100.0)		3,898	(3,898)	(100.0)
Co-promotion fees	50,294	70,346	(20,052)	(28.5)	162,615	162,588	27	<1.0
Total selling, general and administrative	$ 157,594	$ 182,450	$ (24,856)	(13.6)%	$ 482,095	$ 472,397	$ 9,698	2.1%

Total selling, general and administrative expenses decreased in the third quarter of 2006 compared to the third quarter of 2005 primarily due to a decrease in co-promotion fees we pay to Wyeth under our Co-Promotion Agreement and

the benefit of special items partially offset by stock based compensation costs. The decrease in co-promotion fees is due to an amendment to the original Co-Promotion Agreement with Wyeth and lower net sales of Altace®. For a discussion regarding the decrease in net sales of Altace®, please see Altace® within the Sales of Key Products section above. For a discussion regarding the Amended Co-Promotion Agreement with Wyeth, please see General within the Liquidity and Capital Resources section below. The Amended Co-Promotion Agreement allows King to assume full responsibility for the selling and marketing of Altace® beginning January 1, 2007. We anticipate that selling and marketing expenses will increase due to this new responsibility.

Total selling, general and administrative expenses increased in the first nine months of 2006 compared to the first nine months of 2005 primarily due to stock based compensation costs and an increase in operating expenses associated with sales and marketing, partially offset by the benefit of special items. While Altace® net sales were higher in the first nine months of 2006 compared to the first nine months of 2005, the co-promotion fee remained consistent due to a lower co-promotion fee average rate during 2006 as a result of the Amended Co-Promotion Agreement. For a discussion regarding the Amended Co-Promotion Agreement, please see General within the Liquidity and Capital Resources section below. For a discussion regarding the increase in net sales of Altace®, please see Altace® within the Sales of Key Products section above.

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Effective January 1, 2006, we adopted Statement of Financial Accounting Standards (SFAS) No. 123(R), Share-Based Payment, using the modified prospective application transition method. Our prior period condensed consolidated financial statements have not been restated and therefore do not reflect the recognition of stock-based compensation costs. During the third quarter of 2006, we incurred stock-based compensation costs of $5.5 million, $4.3 million of which is included in selling, general and administrative expenses. During the first nine months of 2006, we incurred stock-based compensation costs of $15.2 million, $11.0 million of which is included in selling, general and administrative expenses.

In addition to the stock-based compensation costs discussed above, we have recorded a charge of $3.6 million in the third quarter of 2006 to correct immaterial understatements of compensation expense identified in our voluntary review of our practices with respect to granting equity-based compensation. For additional information, please see *Review of Historical Equity-Based Compensation Grants* included in Note 2, Stock-Based Compensation, in Item 1, Financial Statements.

Selling, general and administrative expense includes the following special items:

A benefit of $5.5 million and $1.0 million in the third quarter of 2006 and the first nine months of 2006, respectively, and charges of $4.4 and $13.3 million in the third quarter of 2005 and the first nine months of 2005, respectively, primarily due to professional fees related to the now completed investigation of our company by the Office of Inspector General of the United States Department of Health and Human Services, the partially completed investigation by the U.S. Securities and Exchange Commission, and private plaintiff securities litigation. During the third quarter of 2006, we recorded an anticipated insurance recovery of legal fees in the amount of $6.8 million related to the securities litigation. In November of 2006, we received payment for the recovery of these legal fees. For additional information, please see Settlement of Governmental Pricing Investigation , SEC Investigation and Securities Litigation included in Note 9, Contingencies, in Item 1 Financial Statements.

A charge in the amount of $0.5 million and $3.9 million in the third quarter and the first nine months of 2005, respectively, for professional fees and expenses related to the terminated merger agreement with Mylan Laboratories, Inc.

As a percentage of total revenues, total selling, general, and administrative expenses were 32.1% in the third quarter of 2006 compared to 35.2% in the third quarter of 2005 and 32.7% in the first nine months of 2006 compared to 35.0% in the first nine months of 2005.

Research and Development Expense

	For the Three Months Ended September 30,		Change 2006 vs. 2005	For the Nine Months Ended September 30,		Change 2006 vs. 2005
	2006	2005	$	2006	2005	$
		(In thousands)			(In thousands)	
Research and development	$ 38,419	$ 24,049	$ 14,370	$ 102,931	$ 53,021	$ 49,910
Research and development in	25,000		25,000	110,000		110,000

process upon acquisition						
Total research and development	$ 63,419	$ 24,049	$ 39,370	$ 212,931	$ 53,021	$ 159,910

Research and development represents expenses associated with the ongoing development of investigational drugs and product life-cycle management projects in our research and development pipeline. These expenses have continued to increase over time as our development programs have progressed to later stages of clinical development, which later stages are much more expensive than earlier stages, and as we have continued to add late-stage products in development to our portfolio.

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Research and development in process upon acquisition represents the actual cost of acquiring rights to novel branded pharmaceutical projects in development from third parties, which costs we expense at the time of acquisition, as the projects have not received regulatory approval and have no alternative future use. During the first and third quarters of 2006 we incurred charges of $85.0 million and $25.0 million, respectively, for our acquisition of in-process research and development associated with our collaboration with Arrow International Limited and certain of its affiliates (collectively, Arrow), not including Cobalt Pharmaceuticals, Inc., to commercialize novel formulations of ramipril, the active ingredient in our Altace® product. Under a series of agreements, Arrow has granted us rights to certain current and future New Drug Applications (NDAs) regarding novel formulations of ramipril and intellectual property, including patent rights and technology licenses relating to these novel formulations. Arrow will have responsibility for the manufacture and supply of new formulations of ramipril for us. However, under certain conditions, we may manufacture and supply the formulations of ramipril instead of Arrow. Additionally, Arrow will earn fees for the manufacture and supply of the new formulations of ramipril. Arrow filed an NDA for a novel formulation of ramipril in January 2006. The success of the project will depend on additional development activities and FDA approval. The estimated cost to complete the project at the execution of the agreement was approximately $3.5 million. Assuming we obtain FDA approval, we currently plan to commercialize the novel formulation during 2007 or 2008.

Depreciation and Amortization Expense

Depreciation and amortization expense increased in the third quarter of 2006 compared to the third quarter of 2005 primarily due to reductions in estimated useful lives of certain assets.

Depreciation and amortization expense decreased in the first nine months of 2006 compared to the first nine months of 2005 primarily due to completing our amortization of the purchase price associated with the patents relating to Skelaxin® in the second quarter of 2005, partially offset by increases in depreciation and amortization due to reductions in estimated useful lives of certain assets.

Depreciation and amortization expense includes a special item of $1.5 million in the third quarter of 2006 and the first nine months of 2006 associated with accelerated depreciation on certain assets including those associated with our decision to transfer the production of Levoxyl® from our St. Petersburg, Florida facility to our Bristol, Tennessee facility by the end of 2008.

As of September 30, 2006, the net intangible assets associated with Intal®, Tilade®, and Synercid® totaled approximately $180.4 million. We believe that these intangible assets are not currently impaired based on estimated undiscounted cash flows associated with these assets. However, if our estimates regarding future cash flows prove to be incorrect or adversely change, we may have to reduce the estimated remaining useful life and/or write-off a portion or all of these intangible assets.

Certain generic pharmaceutical companies have challenged patents on Altace®, Skelaxin®, and Sonata®. For additional information, please see Other Legal Proceedings included in Note 9, Contingencies, in Item 1, Financial Statements. If generic versions of Altace®, Skelaxin® or Sonata® enter the market, we may have to write off a portion or all of the intangible assets associated with these products.

Our Rochester, Michigan facility manufactures products for us and various third-parties. As of September 30, 2006, the net carrying value of the property, plant and equipment at the Rochester facility, excluding that associated with the production of Bicillin®, was $63.0 million. Overall production volume at this facility declined in recent years. We are currently transferring to this facility the manufacture of certain products that are currently manufactured by us at other facilities or for us by third parties. These transfers should increase production and cash flow at the Rochester facility. We currently believe that the long-term assets associated with the Rochester facility are not impaired based on estimated undiscounted future cash flows. However, if production volumes decline further or if we are not successful

in transferring additional production to the Rochester facility, we may have to write off a portion of the property, plant and equipment associated with this facility.

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The net book value of some of our manufacturing facilities currently exceeds fair market value. We currently believe that the long-term assets associated with these facilities are not impaired based on estimated undiscounted future cash flows. During the third quarter of 2006, we have shortened the useful lives of assets related to the St. Petersburg facility and certain other affected assets, as discussed above. If we were to approve a plan to sell or close any additional facilities for which the carrying value exceeds fair market value, we would have to write off a portion of the assets, or reduce the estimated useful life of the assets, which would accelerate depreciation.

Other Operating Expenses

In addition to the special items described above, we incurred other special items affecting operating costs and expenses. These other special items included the following:

Intangible asset impairment charges of $0.3 million in the first nine months of 2006 and $126.9 million in the first nine months of 2005. The intangible asset impairment charge in 2005 was related to Sonata®. As previously disclosed, a new competitor to Sonata® entered the market in April 2005. In the second quarter of 2005, the prescriptions for Sonata® did not meet our expectations. As a result, we lowered our future sales forecast for Sonata® which resulted in a decrease in the estimated undiscounted future cash flows associated with the carrying value of the Sonata® intangible assets on our balance sheet so as to reflect the estimated fair value of such assets. We determined the fair value of the intangible assets associated with Sonata® based on the estimated discounted future cash flows for this product.

A restructuring charge in the amount of $2.6 million in the first nine months of 2005 primarily due to our decision to discontinue some relatively insignificant products associated with our Meridian Medical Technologies segment.

A restructuring charge in the amount of $3.2 million in the third quarter of 2006 associated with separation payments primarily due to our decision to transfer the production of Levoxyl® from our St. Petersburg, Florida facility to the Bristol, Tennessee facility by the end of 2008.

A gain of $1.5 million in first nine months of 2005 primarily due to the sale of some of our assets.

Non-Operating Items

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2006	2005	2006	2005
	(In thousands)		(In thousands)	
Interest income	$ 8,489	$ 5,253	$ 22,842	$ 11,463
Interest expense	(1,894)	(3,136)	(7,925)	(8,876)
Gain (loss) on investment		1,040		(6,182)
(Loss) gain on early extinguishment of debt	(11)		698	
Other, net	101	(751)	(613)	(2,047)
Total other income (expense)	6,685	2,406	15,002	(5,642)
Income tax expense	40,020	67,109	123,931	111,302
Discontinued operations	555	(787)	497	1,618

Other Income (Expense)

Interest income increased during the third quarter of 2006 compared to the third quarter of 2005 and in the first nine months of 2006 compared to the first nine months of 2005 primarily due to an increase in interest rates and a higher average balance of cash, cash equivalents and investments in debt securities in 2006 compared to 2005.

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Special items affecting other income (expense) included the following:

A gain of $1.0 million in the third quarter of 2005 and a charge of $6.2 million in the first nine months of 2005 related to our investment in Novavax, Inc. We sold our investment in Novavax, Inc. during the third quarter of 2005.

Income of $0.7 million during the first nine months of 2006 resulting from the early retirement of our 23/4% Convertible Debentures due November 15, 2021.

Income Tax Expense

During the third quarter of 2006 and the first nine months of 2006, our effective income tax rate for continuing operations was 30.8% and 33.0%, respectively. This rate differs from the statutory rate of 35% primarily due to benefits related to charitable contributions of inventory, tax-exempt interest income and domestic manufacturing deductions, which benefits were partially offset by state taxes.

During the third quarter of 2005, our effective tax rate for continuing operations was 35.4%. This rate differs from the statutory rate of 35% primarily due to state taxes partially offset by tax benefits associated with charitable contributions of inventory and tax-exempt interest income. During the first nine months of 2005, our effective income tax rate for continuing operations was 34.6%. This rate differs from the statutory rate of 35% due primarily to tax benefits related to charitable contributions of inventory and tax-exempt interest income partially offset by state taxes.

Discontinued Operations

During the first quarter of 2004, our Board of Directors approved management s decision to market for divestiture some of our women s health products, including Prefest® and Nordette®, which we sold in the fourth quarter of 2004. These product rights had identifiable cash flows that were largely independent of the cash flows of other groups of assets and liabilities and are classified as discontinued operations. Accordingly, all net sales, cost of revenues, selling, general and administrative costs, amortization and other operating costs associated with Prefest® and Nordette® are included in discontinued operations in 2006 and 2005. Results of discontinued operations during 2006 and 2005 are primarily due to changes in estimated reserves for returns and rebates.

LIQUIDITY AND CAPITAL RESOURCES

General

We believe that existing balances of cash, cash equivalents, investments in debt securities and marketable securities, cash generated from operations, our existing revolving credit facility and funds potentially available to us under our universal shelf registration are sufficient to finance our current operations and working capital requirements on both a short-term and long-term basis. However, we cannot predict whether the amount or timing of our need for additional funds under various circumstances, which could include a significant acquisition of a business or assets, new product development projects, expansion opportunities, or other factors that may require us to raise additional funds in the future. Our current revolving credit facility expires in April 2007. We cannot assure you that funds will be available to us when needed on favorable terms, or at all.

On September 6, 2006, we entered into a definitive asset purchase agreement and related agreements with Ligand Pharmaceuticals Incorporated (Ligand) to acquire rights to Ligand s Avinza® (morphine sulfate extended release). Avinza® is an extended release formulation of morphine and is indicated as a once-daily treatment for moderate-to-severe pain in patients who require continuous, around-the-clock opioid therapy for an extended period of

time. Under the terms of the asset purchase agreement, on the closing of the transaction, we will make a $265.0 million payment to Ligand to acquire all the rights to Avinza® in the United States, its territories and Canada. The closing payment is subject to adjustment based on Ligand s ability to reduce wholesale and retail inventory levels of Avinza® to certain targeted levels by the closing date. In addition, we will assume certain liabilities, including a product related liability totaling $47.8 million.

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As part of the Transaction, we have agreed to pay Ligand an ongoing royalty, to assume payment of Ligand s royalty obligations to Organon and to assume payment of royalty obligations to other third parties. The royalty we will pay to Ligand consists of a 15% royalty during the first 20 months after the closing date, a subsequent royalty based upon calendar year net sales such that if calendar year net sales are less than $200.0 million the royalty payment will be 5% of all net sales; if calendar year net sales are greater than $200.0 million then the royalty payment will be 10% of all net sales up to $250 million, plus 15% of net sales greater than $250.0 million.

In connection with the transaction, we entered into a loan agreement with Ligand for the amount of $37.8 million on October 12, 2006. The principal amount of the loan may be used solely for the purpose of paying a specific liability related to Avinza®. The loan is subject to certain market terms, including a 9.5% interest rate and security interest in the assets that comprise Avinza® and certain of the proceeds of Ligand s sale of certain assets. If the closing of the transaction occurs on or before January 8, 2007, we will forgive any accrued interest on the loan and the outstanding principal amount due thereunder would be credited against the purchase price for the Avinza® assets. If the closing of the transaction does not occur by January 8, 2007, the outstanding principal amount of the loan, accrued interest, as well as additional default interest of 2% from January 1, 2007 to January 8, 2007, would become due on January 9, 2007.

The transaction is conditioned upon the approval of Ligand s shareholders and other customary conditions. We anticipate that the transaction will close on or about December 31, 2006.

On June 22, 2000, we entered into a Co-Promotion Agreement with Wyeth to promote Altace® in the United States and Puerto Rico through October 29, 2008, with possible extensions as outlined in the Co-Promotion Agreement. Under the agreement, Wyeth paid an upfront fee to us of $75.0 million. In connection with the Co-Promotion Agreement, we agreed to pay Wyeth a promotional fee based on annual net sales of Altace®. On July 5, 2006, we entered into an amended and restated co-promotion agreement (Amended Co-Promotion Agreement) with Wyeth regarding Altace®. Effective January 1, 2007, we will assume full responsibility for the selling and marketing of Altace®. For the remainder of 2006, the Wyeth sales force will continue to promote the product with us and Wyeth will continue to share marketing expenses for the remainder of 2006. We will pay Wyeth a reduced annual fee as follows:

For 2006, 15% of Altace® net sales up to $165.0 million, 42.5% of Altace® net sales in excess of $165.0 million and less than or equal to $465.0 million, and 52.5% of Altace® net sales that are in excess of $465.0 million and less than or equal to $585.0 million. The fee in 2006 will not exceed $215.3 million.

For 2007, 30% of Altace® net sales, with the fee not to exceed $178.5 million.

For 2008, 22.5% of Altace® net sales, with the fee not to exceed $134.0 million.

For 2009, 14.2% of Altace® net sales, with the fee not to exceed $84.5 million.

For 2010, 25% of Altace® net sales, with the fee not to exceed $5.0 million.

The annual fee is accrued quarterly based on a percentage of Altace® net sales at a rate equal to the expected relationship of the expected fee for the quarter to applicable expected Altace® net sales for the year.

Wyeth will pay us a $20.0 million milestone fee if a specified Altace® net sales threshold is achieved in 2008.

On June 27, 2006, we entered into a co-exclusive agreement with Depomed, Inc. (Depomed) to commercialize Depomed s Glumetza™ product. Glumetza™ is a once-daily, extended-release formulation of metformin for the

treatment of patients with Type II diabetes that Depomed developed utilizing its proprietary Acuform[tm] drug delivery technology. Under the terms of the agreement, we assumed responsibility for selling Glumetza[tm] in the United States and Puerto Rico, while Depomed has the right to co-promote the product using its own sales force at some point in the future. Depomed will pay us a fee from gross profit, as defined in the agreement, generally net sales less cost of goods sold less a royalty Depomed must pay a third party.

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Depomed is responsible for the manufacture and distribution of Glumetza™, while we bear all costs related to the utilization of our sales force for the product. We launched Glumetza™ in the third quarter of 2006.

On March 1, 2006, we acquired the exclusive right to market, distribute, and sell EpiPen® throughout Canada and other specific assets from Allerex Laboratory LTD. Under the terms of the agreements, the initial purchase price was approximately $23.9 million, plus acquisition costs of approximately $0.7 million. As an additional component of the purchase price, we pay Allerex an earn-out equal to a percentage of future sales of EpiPen® in Canada over a fixed period of time. As these additional payments accrue, we will increase intangible assets by the amount of the accrual. The aggregate of these payments will not exceed $13.2 million.

On February 12, 2006, we entered into a collaboration with Arrow to commercialize novel formulations of ramipril, the active ingredient in our Altace® product. Under a series of agreements, Arrow granted us rights to certain current and future New Drug Applications (NDAs) regarding novel formulations of ramipril and intellectual property, including patent rights and technology licenses relating to these novel formulations. Arrow will have responsibility for the manufacture and supply of the new formulations of ramipril for us. However, under certain conditions we may manufacture and supply new formulations of ramipril.

Upon execution of the agreements, we made an initial payment to Arrow of $35.0 million. Arrow will also receive payments from us of $75.0 million based on the timing of certain events. Additionally, Arrow will earn fees for the manufacture and supply of the new formulations of ramipril.

We entered into an agreement with Cobalt Pharmaceuticals, Inc. (Cobalt), an affiliate of Arrow, whereby Cobalt will have the non-exclusive right to distribute a generic version of our currently marketed Altace® product in the U.S. market, which would be supplied by us.

In December 2005, we entered into a cross-license agreement with Mutual. Under the terms of the agreement, each of the parties has granted the other a worldwide license to certain intellectual property, including patent rights and know-how, relating to metaxalone. As of January 1, 2006, we began paying royalties on net sales of products containing metaxalone to Mutual. This royalty will increase in the fourth quarter of 2006 due to the achievement of a certain regulatory milestone and may continue to increase depending on the achievement of certain regulatory and commercial milestones in the future. The royalty we pay to Mutual is in addition to the royalty we pay to Elan Corporation, plc (Elan) on our current formulation of metaxalone, which we refer to as Skelaxin®.

During the fourth quarter of 2005, the Company entered into a strategic alliance with Pain Therapeutics, Inc. to develop and commercialize Remoxy™ and other abuse-deterrent opioid painkillers. Remoxy™ is an investigational drug in late-stage clinical development by Pain Therapeutics for the treatment of moderate-to-severe chronic pain. Under the strategic alliance, we made an upfront cash payment of $150.0 million in December 2005 and made a milestone payment of $5.0 million in July 2006 to Pain Therapeutics. In addition, we may pay additional milestone payments of up to $145.0 million in cash based on the successful clinical and regulatory development of Remoxy™ and other abuse-deterrent opioid products. This amount includes a $15.0 million cash payment upon acceptance of a regulatory filing for Remoxy™ and an additional $15.0 million upon its approval. We are responsible for all research and development expenses related to this alliance, which could total $100.0 million over four years. After regulatory approval and commercialization of Remoxy™ or other products developed through this alliance, we will pay a royalty of 15% of the cumulative net sales up to $1.0 billion and 20% of the cumulative net sales over $1.0 billion.

In August 2004, we entered into a collaborative agreement with Palatin Technologies, Inc. to jointly develop and, on obtaining necessary regulatory approvals, commercialize Palatin s bremelanotide, which we formerly referred to as PT-141, for the treatment of male and female sexual dysfunction. In connection with this agreement, we agreed to pay potential milestone payments to Palatin of up to $100.0 million upon achieving certain development and regulatory

approval targets, $10.0 million of which was paid in September 2005. In the event of regulatory approval and commercialization of bremelanotide, we may also pay potential net sales milestone payments to Palatin of up to $130.0 million.

Elan was working to develop a modified release formulation of Sonata®, which we refer to as Sonata® MR, pursuant to an agreement we had with them which we refer to as the Sonata® MR Development

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Agreement. In early 2005, we advised Elan that we considered the Sonata® MR Development Agreement terminated. On August 26, 2005, Elan filed a request for mediation pursuant to the terms of the Sonata® MR Development Agreement. We participated in mediation with Elan in early 2006, which did not result in an agreed resolution. The Sonata® MR Development Agreement requires us to pay up to an additional $60.0 million if Elan achieves certain milestones in connection with the development of a reformulated version of Sonata® and $15.0 million as a milestone payment if annual net sales of a reformulated version of Sonata® exceed $100.0 million, plus costs associated with the development of a reformulated version of Sonata®. We believe these milestones have not been and cannot in the future be achieved. In September 2006, we participated in an arbitration proceeding with Elan concerning this dispute. Post-hearing briefs were submitted in October 2006 and were followed by oral argument in late October 2006. A decision of the arbitration panel is expected in December 2006.

Settlement of Governmental Pricing Investigation

On October 31, 2005, we entered into (i) a definitive settlement agreement with the United States of America, acting through the United States Department of Justice and the United States Attorney s Office for the Eastern District of Pennsylvania and on behalf of the HHS/OIG and the Department of Veterans Affairs, to resolve the governmental investigations related to our underpayment of rebates owed to Medicaid and other governmental pricing programs during the period from 1994 to 2002 (the Federal Settlement Agreement), and (ii) similar settlement agreements with 48 states and the District of Columbia (collectively, the 2005 State Settlement Agreements). On March 6, 2006, we entered into a definitive settlement agreement with the remaining state on substantially the same terms as the other state settlements (this most recent state settlement, the Federal Settlement Agreement and the 2005 State Settlement Agreements are collectively referred to as the Settlement Agreements). Consummation of the Federal Settlement Agreement and some state Settlement Agreements was subject to court approval, which was granted by the United States District Court for the Eastern District of Pennsylvania (District Court) during the first quarter of 2006.

During the first quarter of 2006, we paid approximately $129.3 million, comprising (i) all amounts due under each of the Settlement Agreements and (ii) all our obligations to reimburse other parties for expenses related to the settlement, including the previously disclosed legal fees of approximately $0.8 million and the previously disclosed settlement costs of approximately $1.0 million.

The individual purportedly acting as a relator under the False Claims Act has appealed certain decisions of the District Court denying the relator s request to be compensated out of the approximately $31 million that was paid by us to those states that do not have legislation providing for a relator s share. The purported relator has asserted for the first time on appeal that we should be responsible for making such a payment to this individual. We believe that this claim against us is without merit and do not expect the result of the appeal to have a material effect on us.

In addition to the Settlement Agreements, we have entered into a five-year corporate integrity agreement with HHS/OIG (the Corporate Integrity Agreement) pursuant to which we are required, among other things, to keep in place our current compliance program, to provide periodic reports to HHS/OIG and to submit to audits relating to our Medicaid rebate calculations.

The previously disclosed claim seeking damages from us because of alleged retaliatory actions against the relator was dismissed with prejudice on January 31, 2006.

The Settlement Agreements will not resolve any of the previously disclosed civil suits that are pending against us and related individuals and entities discussed in the section Securities Litigation below.

The foregoing description of the settlement, the Settlement Agreements and the Corporate Integrity Agreement is qualified in its entirety by our Current Report on Form 8-K filed November 4, 2005, which is incorporated herein by

reference.

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SEC Investigation

As previously reported, the Securities and Exchange Commission (SEC) has also been conducting an investigation relating to our underpayments to governmental programs, as well as into our previously disclosed errors relating to reserves for product returns. While the SEC s investigation is continuing with respect to the product returns issue, the Staff of the SEC has advised us that it has determined not to recommend enforcement action against us with respect to the aforementioned governmental pricing matter. The Staff of the SEC notified us of this determination pursuant to the final paragraph of Securities Act Release 5310. Although the SEC could still consider charges against individuals in connection with the governmental pricing matter, we do not believe that any governmental unit with authority to assert criminal charges is considering any charges of that kind.

We continue to cooperate with the SEC s ongoing investigation. Based on all information currently available to us, we do not anticipate that the results of the SEC s ongoing investigation will have a material adverse effect on us, including by virtue of any obligations to indemnify current or former officers and directors.

Securities Litigation

Subsequent to the announcement of the SEC investigation described above, beginning in March 2003, 22 purported class action complaints were filed by holders of our securities against King, our directors, former directors, executive officers, former executive officers, our subsidiary, and a former director of the subsidiary in the United States District Court for the Eastern District of Tennessee, alleging violations of the Securities Act of 1933 and/or the Securities Exchange Act of 1934, in connection with our underpayment of rebates owed to Medicaid and other governmental pricing programs, and certain transactions between us and the Benevolent Fund. These 22 complaints have been consolidated in the United States District Court for the Eastern District of Tennessee. In addition, holders of our securities filed two class action complaints alleging violations of the Securities Act of 1933 in Tennessee state court. We removed these two cases to the United States District Court for the Eastern District of Tennessee, where these two cases were consolidated with the other class actions. Plaintiffs in these actions unsuccessfully moved to remand these two cases back to Tennessee state court. These two actions therefore remain part of the consolidated action. The district court has appointed lead plaintiffs in the consolidated action, and those lead plaintiffs filed a consolidated amended complaint on October 21, 2003 alleging that King, through some of our executive officers, former executive officers, directors, and former directors, made false or misleading statements concerning our business, financial condition, and results of operations during periods beginning February 16, 1999 and continuing until March 10, 2003. Plaintiffs in the consolidated action have also named the underwriters of our November 2001 public offering as defendants. We and other defendants filed motions to dismiss the consolidated amended complaint.

On August 12, 2004, the United States District Court for the Eastern District of Tennessee ruled on defendants motions to dismiss. The Court dismissed all claims as to Jones Pharma, Inc. and as to defendants Dennis Jones and Henry Richards. The Court also dismissed certain claims as to five other individual defendants. The Court denied the motions to dismiss in all other respects. Following the Court s ruling, on September 20, 2004, the Company and the other remaining defendants filed answers to plaintiffs consolidated amended complaint.

In November 2005, the parties agreed to submit the matter to non-binding mediation. After an extensive mediation process, an agreement in principle to settle the litigation was reached on April 26, 2006. On July 31, 2006, the parties entered into a stipulation of settlement and a supplemental agreement (together, the Settlement Agreement) to resolve the litigation. On September 27, 2006, the court granted preliminary approval of the Settlement Agreement. Consummation of the Settlement Agreement is still subject to certain conditions, including, among others, final court approval. The Settlement Agreement provides for a settlement amount of $38.3 million. Prior to the Settlement Agreement, the court established April 10, 2007 as the trial date.

We previously estimated a probable loss contingency of $38.3 million for the class action lawsuit described above. We believe all but an immaterial portion of this loss contingency will be paid on behalf of us

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by our insurance carriers. Accordingly, we previously recorded a liability and a receivable for this amount, which are classified in accrued expenses and prepaid and other current assets, respectively, in our consolidated financial statements.

Beginning in March 2003, four purported shareholder derivative complaints were also filed in Tennessee state court alleging a breach of fiduciary duty, among other things, by some of our current and former officers and directors, with respect to the same events at issue in the federal securities litigation described above. These cases have been consolidated, and on October 3, 2003, plaintiffs filed a consolidated amended complaint. On November 17, 2003, defendants filed a motion to dismiss or stay the consolidated amended complaint. The court denied the motion to dismiss, but granted a stay of proceedings. On October 11, 2004, the court lifted the stay to permit plaintiffs to file a further amended complaint adding class action claims related to our then-anticipated merger with Mylan Laboratories, Inc. On October 26, 2004, defendants filed a partial answer to the further amended complaint, and moved to dismiss the newly-added claims. Following the termination of the Mylan merger agreement, plaintiffs voluntarily dismissed these claims. On October 11, 2006, plaintiffs voluntarily dismissed Brian Markison and Elizabeth Greetham. Discovery with respect to the remaining claims in the case has commenced. No trial date has been set.

Beginning in March 2003, three purported shareholder derivative complaints were likewise filed in Tennessee federal court, asserting claims similar to those alleged in the state derivative litigation. These cases have been consolidated, and on December 2, 2003 plaintiffs filed a consolidated amended complaint. On March 9, 2004, the court entered an order indefinitely staying these cases in favor of the state derivative action.

In August 2004, a separate class action lawsuit was filed in Tennessee state court, asserting claims solely with respect to our then-anticipated merger with Mylan Laboratories. Defendants filed a motion to dismiss the case on November 30, 2004. On March 14, 2006, plaintiff voluntarily dismissed the case. On June 12, 2006, plaintiff filed a motion requesting an award of attorneys fees and expenses in the amount of $1.5 million. On October 18, 2006, plaintiffs modified their motion asking the court to determine whether plaintiffs are entitled to an award of reasonable attorneys fees and expenses. This motion is pending.

During the third quarter of 2006, we recorded an anticipated insurance recovery of legal fees in the amount of $6.8 million for the class action and derivative suits described above. In November of 2006, we received payment for the recovery of these legal fees.

We are unable currently to predict the outcome or to reasonably estimate the range of potential loss, if any, except as noted above, in the pending litigation. If we were not to prevail in the pending litigation, the outcome of which we cannot predict or reasonably estimate at this time, our business, financial condition, results of operations and cash flows could be materially adversely affected. Defending us in the pending litigation has resulted, and could continue to result, in a significant diversion of management s attention and resources and the payment of additional professional fees.

Patent Challenges

Certain manufacturers of generic pharmaceutical products have challenged patents on Altace®, Skelaxin®, Sonata® and Adenoscan®. For additional information, please see Other Legal Proceedings included in Note 9, Contingencies, in Item 1, Financial Statements. If a generic version of Altace®, Skelaxin®, Sonata® or Adenoscan® enters the market, our business, financial condition, results of operations and cash flows could be materially adversely affected.

Cash Flows

Operating Activities

	For the Nine Months Ended September 30,	
	2006	2005
	(In thousands)	
Net cash provided by operating activities	$ 297,257	$ 404,823

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Our net cash from operations was lower in 2006 than in 2005 primarily due to changes in working capital which are outlined below, the effect of which was partially offset by an increase in gross profit. The decrease caused by changes in working capital was primarily due to our payment during the first quarter of 2006 of $129.3 million pursuant to the Settlement Agreements described in the section entitled Settlement of Government Pricing Investigation above. Please see the section entitled Results of Operations for a discussion of net sales.

The allowance for doubtful accounts was $5.6 million and $12.3 million as of September 30, 2006 and December 31, 2005, respectively. The decline in the allowance for doubtful accounts is primarily driven by the settlement of a past due account in the third quarter of 2006 which was previously fully reserved and the improvements in the aging of receivables during the first nine months of 2006. As of September 30, 2006 and December 31, 2005, approximately 93% and 89% of aged accounts receivable, respectively, were current. Additionally, after adjusting for the specific identification of certain accounts, the accounts greater than 120 days past due improved from $13.6 million at December 31, 2005 to $6.8 million at September 30, 2006.

The following table summarizes the changes in operating assets and liabilities and deferred taxes that occurred during the nine months ending September 30, 2006 and 2005 and the resulting effect on cash flows from operations:

	For the Nine Months Ended September 30,	
	2006	2005
	(In thousands)	
Accounts receivable, net of allowance	$ (31,015)	$ (72,441)
Inventories	41,293	55,673
Prepaid expenses and other current assets	(43,567)	(9,180)
Accounts payable	(5,552)	(32,810)
Accrued expenses and other liabilities	(114,547)	(26,774)
Income taxes payable	(1,537)	64,346
Deferred revenue	(5,716)	(6,819)
Other assets	(20,256)	(2,894)
Deferred taxes	(13,853)	(23,179)
Total changes in operating assets and liabilities and deferred taxes	$ (194,750)	$ (54,078)

Investing Activities

	For the Nine Months Ended September 30,	
	2006	2005
	(In thousands)	
Net cash used in investing activities	$ (247,266)	$ (517,931)

Changes in investing activities in 2006 primarily relate to our net investments in debt securities of $284.9 million. We transferred $129.3 million from restricted cash for payments associated with the Settlement Agreements noted above in cash flows from operating activities. Additionally we made payments totaling $59.9 million for our collaboration agreement with Arrow and certain of its affiliates and our acquisition from Allerex Laboratory LTD of the exclusive

right to market Epipen® in Canada. Capital expenditures during 2006 totaled $31.2 million which included property, plant and equipment purchases, building improvements for facility upgrades and costs associated with improving our production capabilities, as well as costs associated with moving production of some of our pharmaceutical products to our facilities in St. Louis, Bristol and Rochester.

Investing activities in 2005 primarily relate to our net investments in debt securities of $408.5 million. Capital expenditures during 2005 totaled $32.3 million which included property, plant and equipment purchases, building improvements for facility upgrades and costs associated with improving our production capabilities, and costs associated with moving production of some of our pharmaceutical products to our

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facilities in St. Louis, Bristol and Rochester. Additionally in 2005, we transferred $73.5 million to restricted cash.

We anticipate capital expenditures, including capital lease obligations, for the year ending December 31, 2006 of approximately $48.0 million, which will be funded with cash from operations. The principal capital expenditures are anticipated to include property and equipment purchases, building improvements for facility upgrades, costs associated with improving our production capabilities, and costs associated with moving production of some of our pharmaceutical products to our facilities in St. Louis, Bristol and Rochester.

Financing Activities

	For the Nine Months Ended September 30,	
	2006	2005
	(In thousands)	
Net cash provided by financing activities	$ 58,049	$ 682

During 2006, we issued $400.0 million of 11/4% Convertible Senior Notes due April 1, 2026 and repurchased almost all of our outstanding 23/4% Convertible Debentures due November 15, 2021 for $338.4 million.

Certain Indebtedness and Other Matters

During the first quarter of 2006, we issued $400.0 million of 11/4% Convertible Senior Notes due April 1, 2026 (Notes). The Notes are unsecured obligations and are guaranteed by each of our domestic subsidiaries on a joint and several basis. The Notes accrue interest at an initial rate of 11/4%. Beginning with the six-month interest period that commences on April 1, 2013, we will pay additional interest during any six-month interest period if the average trading price of the Notes during the five consecutive trading days ending on the second trading day immediately preceding the first day of such six-month period equals 120% or more of the principal amount of the Notes. Interest is payable on April 1 and October 1 of each year, beginning October 1, 2006.

On or after April 5, 2013, we may redeem for cash some or all of the Notes at any time at a price equal to 100% of the principal amount of the Notes to be redeemed, plus any accrued and unpaid interest, and liquidated damages, if any, to but excluding the date fixed for redemption. Holders may require us to purchase for cash some or all of their Notes on April 1, 2013, April 1, 2016 and April 1, 2021, or upon the occurrence of a fundamental change, at 100% of the principal amount of the Notes to be purchased, plus any accrued and unpaid interest and liquidated damages, if any, to but excluding the purchase date.

During the fourth quarter of 2001, we issued $345.0 million of 23/4% Convertible Debentures due November 15, 2021 (Debentures). On March 29, 2006, we repurchased $165.0 million of the Debentures prior to maturity. On June 2, 2006, we completed a tender offer, repurchasing $175.7 million of the Debentures. As of September 30, 2006, we had outstanding $4.3 million of these Debentures. On October 6, 2006, we sent a notice of redemption to the trustee of our Debentures that we will redeem all of the outstanding Debentures on November 20, 2006. In accordance with the optional redemption provisions of the indenture of the Debentures, we will redeem the Debentures at a price of 100% of the principal amount thereof plus accrued interest. Holders may require us to repurchase for cash all or part of these Debentures on November 15, 2006, November 15, 2011, and November 15, 2016 at a price equal to 100% of the principal amount of the Debentures plus accrued interest up to, but not including, the date of repurchase. On May 16, 2006, the interest rate on the Debentures reset to 3.5%.

We also had available as of September 30, 2006 up to $399.0 million under a five-year senior secured revolving credit facility that we established in April 2002. Our senior secured revolving credit facility matures in April 2007. The facility is collateralized in general by all of our real estate with a value of $5.0 million or more and all of our personal property and that of our significant subsidiaries. Our obligations under the senior secured revolving credit facility are unconditionally guaranteed on a senior basis by most of our subsidiaries. The senior secured revolving credit facility accrues interest at our option, at either (a) the base rate, which is

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based on the greater of (1) the prime rate or (2) the federal funds rate plus one-half of 1%, plus an applicable spread ranging from 0.0% to 0.75% (based on a leverage ratio) or (b) the applicable LIBOR rate plus an applicable spread ranging from 1.0% to 1.75% (based on a leverage ratio). In addition, the lenders under the senior secured revolving credit facility are entitled to customary facility fees based on (a) unused commitments under the facility and (b) letters of credit outstanding. We incurred $5.1 million of deferred financing costs in connection with the establishment of this facility, which are being amortized over five years, the life of the senior secured revolving credit facility. This facility requires us to maintain a minimum net worth of no less than $1.2 billion plus 50% of our consolidated net income for each fiscal quarter after April 23, 2002, excluding any fiscal quarter for which consolidated income is negative; an EBITDA (earnings before interest, taxes, depreciation and amortization) to interest expense ratio of no less than 3.00 to 1.00; and a funded debt to EBITDA ratio of no greater than 3.50 to 1.00 prior to April 24, 2004 and of no greater than 3.00 to 1.00 on or after April 24, 2004. As of September 30, 2006, we were in compliance with these covenants. As of September 30, 2006, we had $1 million outstanding for letters of credit under this facility.

On September 20, 2001, our universal shelf registration statement on Form S-3 was declared effective by the Securities and Exchange Commission. This universal shelf registration statement registered a total of $1.3 billion of our securities for future offers and sales in one or more transactions and in any combination of debt and/or equity. During November 2001, we completed the sale of 17,992,000 newly issued shares of common stock for $38.00 per share ($36.67 per share net of commissions and expenses) resulting in net proceeds of $659.8 million. As of September 30, 2006, there was $616.3 million of securities remaining registered for future offers and sales under the shelf registration statement.

Impact of Inflation

We have experienced only moderate raw material and labor price increases in recent years. While we have passed some price increases along to our customers, we have primarily benefited from sales growth negating most inflationary pressures.

RECENTLY ISSUED ACCOUNTING STANDARDS

In November 2004, the Financial Accounting Standards Board issued SFAS No. 151, Inventory Costs , an amendment of Accounting Research Bulletin No. 43. SFAS No. 151 requires certain production overhead costs to be allocated to inventory based upon the normal capacity of the manufacturing facility. When our manufacturing facilities are operating below their normal capacity, unfavorable variances cannot be allocated to inventory and must be expensed in the period in which they are incurred. Normal capacity is not defined as full capacity by SFAS No. 151. SFAS No. 151 instead provides that normal capacity refers to a range of production levels expected to be achieved over a number of periods or seasons under normal circumstances. We previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2005, that the estimated utilization was approximately 20% at the Rochester, Michigan facility, approximately 30% at the Bristol, Tennessee facility, approximately 65% at the St. Petersburg, Florida facility, approximately 75% at the St. Louis, Missouri facility and approximately 100% at the Middleton, Wisconsin facility. No material changes have since occurred. We believe all of our operating facilities, except for the Rochester, Michigan facility, are currently operating at levels considered to be normal capacity as defined by SFAS No. 151 as these plants have operated at their current levels for a number of periods and are expected to continue to operate within a range of this normal capacity in the foreseeable future. The margins provided by branded pharmaceutical products are such that they allow manufacturers to operate facilities at lower volumes, or at volumes below theoretical capacity. Additionally, lower capacity levels at certain facilities are, at times, due to the complexity and high regulatory standards associated with the pharmaceutical manufacturing process. With respect to our Bristol, Tennessee facility, we anticipate no abnormally higher or lower production levels in the current year and, therefore, have concluded that the projected level of production is within a range of normal capacity and the margins on the branded pharmaceutical products produced and this facility will result in an adequate return on our investment.

Consequently, we believe that it is appropriate to use the expected production level to allocate fixed production overhead. The Rochester facility is currently operating at a level below normal capacity primarily due to a decline in contract manufacturing in recent years. The company-owned products

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manufactured at this facility are not among our higher margin products. In 2003, we began expensing, and continue to expense, a portion of the fixed overhead costs of this facility as period costs in accordance with Accounting Research Bulletin No. 43. Accordingly, the adoption of SFAS No. 151, as of January 1, 2006, did not have an incremental effect on our financial statements.

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109* (FIN 48), which clarifies the accounting for uncertainty in tax positions. The provisions of FIN 48 are effective for fiscal years beginning after December 15, 2006. We are currently evaluating the effect of FIN 48 on our financial statements and currently plan to adopt this interpretation in the first quarter of 2007.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS No. 157). This statement defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. The statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We are in the process of evaluating the effect of SFAS No. 157 on our financial statements and are planning to adopt this standard in the first quarter of 2008.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB statements No. 87, 88, 106, and 132(R) (SFAS No. 158). This statement amends the guidance in various standards related to pensions and other postretirement benefit plans. In addition to new disclosure requirements, this statement requires an employer to recognize the overfunded or underfunded status of a defined benefit post-retirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. This statement also requires the measurement of defined benefit plan assets and obligations as of the date of the employer s fiscal year-end statement of financial position. The disclosure and recognition requirements of this statement become effective as of the end of the fiscal year ending after December 15, 2006 while the requirement to measure plan assets and benefit obligations as of the date of the employer s fiscal year-end is effective for fiscal years ending after December 15, 2008. We are in the process of evaluating the effect of SFAS No. 158 on our financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements for the Purpose of a Materiality Assessment, (SAB 108) which was issued in order to eliminate the diversity of practice in quantifying financial statement misstatements. It requires quantification of financial statement misstatements based on the effects of the misstatements on each of the company s financial statements and the related financial statement disclosures. The provisions of SAB 108 must be applied to annual financial statements no later than the first fiscal year ending after November 15, 2006. We have assessed the effect of adopting this guidance and have determined that there will be no impact on our financial statements.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

We have chosen accounting policies that we believe are appropriate to accurately and fairly report our operating results and financial position, and apply those accounting policies in a consistent manner.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period.

Significant estimates for which it is reasonably possible that a material change in estimate could occur in the near term include forecasted future cash flows used in testing for impairments of intangible and tangible assets and loss accruals for excess inventory and fixed purchase commitments under our supply contracts. Forecasted future cash flows in particular require considerable judgment and are subject to inherent imprecision. In the case of impairment testing, changes in estimates of future cash flows could result in a material

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impairment charge and, whether they result in an immediate impairment charge, could result prospectively in a reduction in the estimated remaining useful life of tangible or intangible assets, which could be material to the financial statements.

Other significant estimates include accruals for Medicaid, Medicare, and other rebates, returns and chargebacks, allowances for doubtful accounts and estimates used in applying the revenue recognition policy and accounting for the Amended and Restated Co-Promotion Agreement with Wyeth.

We are subject to risks and uncertainties that may cause actual results to differ from the related estimates, and our estimates may change from time to time in response to actual developments and new information.

The significant accounting estimates that we believe are important to aid in fully understanding our reported financial results include the following:

Intangible assets, goodwill, and other long-lived assets. When we acquire product rights in conjunction with either business or asset acquisitions, we allocate an appropriate portion of the purchase price to intangible assets, goodwill and other long-lived assets. The purchase price is allocated to product rights and trademarks, patents, acquired research and development, if any, and other intangibles using the assistance of valuation experts. We estimate the useful lives of the assets by factoring in the characteristics of the products such as: patent protection, competition from products prescribed for similar indications, estimated future introductions of competing products, and other issues. The factors that drive the estimate of the life of the asset are inherently uncertain. However, patents have specific legal lives over which they are amortized. Conversely, trademarks and product rights have no specific legal lives. Trademarks and product rights will continue to be an asset to us after the expiration of the patent, as their economic value is not tied exclusively to the patent. We believe that by establishing separate lives for the patent versus the trademark and product rights, we are in essence using an accelerated method of amortization for the product as a whole. This results in greater amortization in earlier years when the product is under patent protection, as we are amortizing both the patent and the trademark and product rights, and less amortization when the product faces potential generic competition, as the amortization on the patent is eliminated. Because we have no discernible evidence to show a decline in cash flows for trademarks and product rights, or for patents, we use the straight-line method of amortization for both intangibles.

We review our property, plant and equipment and intangible assets for possible impairment whenever events or circumstances indicate that the carrying amount of an asset may not be recoverable. We review our goodwill for possible impairment annually, or whenever events or circumstances indicate that the carrying amount may not be recoverable. In any event, we evaluate the remaining useful lives of our intangible assets each reporting period to determine whether events and circumstances warrant a revision to the remaining period of amortization. This evaluation is performed through our quarterly evaluation of intangibles for impairment. Further, on an annual basis, we review the life of each intangible asset and make adjustments as deemed appropriate. In evaluating goodwill for impairment, we estimate the fair value of our individual business reporting units on a discounted cash flow basis. Assumptions and estimates used in the evaluation of impairment may affect the carrying value of long-lived assets, which could result in impairment charges in future periods. Such assumptions include projections of future cash flows and, in some cases, the current fair value of the asset. In addition, our depreciation and amortization policies reflect judgments on the estimated useful lives of assets.

We may incur impairment charges in the future if prescriptions for, or sales of, our products are less than current expectations and result in a reduction of our estimated undiscounted future cash flows. This may be caused by many factors, including competition from generic substitutes, significant delays in the manufacture or supply of materials, the publication of negative results of studies or clinical trials, new legislation or regulatory proposals.

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The gross carrying amount and accumulated amortization of our trademarks and product rights as of September 30, 2006 are as follows:

	Cost	Accumulated Amortization	Net Book Value
		(In thousands)	
Branded			
Altace®	$ 276,150	$ 81,246	$ 194,904
Other Cardiovascular/metabolic	80,770	43,598	37,172
Cardiovascular/metabolic	356,920	124,844	232,076
Intal®	106,192	20,572	85,620
Other Hospital/acute care	191,114	54,920	136,194
Hospital/acute care	297,306	75,492	221,814
Skelaxin®	203,015	44,292	158,723
Sonata®	23,146	23,146	
Neuroscience	226,161	67,438	158,723
Other	144,675	59,991	84,684
Total Branded	1,025,062	327,765	697,297
Meridian Medical Technologies	172,013	22,531	149,482
Royalties	2,470	2,114	356
Contract manufacturing			
All other			
Total trademarks and product rights	$ 1,199,545	$ 352,410	$ 847,135

The amounts for impairments and amortization expense and the amortization period used for the three months ended September 30, 2006 and 2005 are as follows:

	Three Months Ended September 30, 2006			Three Months Ended September 30, 2005	
	Impairments	Amortization Expense	Life (Years)	Impairments	Amortization Expense
	(In thousands)			(In thousands)	
Branded					
Altace®	$	$ 3,677	21	$	$ 3,225
Other Cardiovascular/metabolic		1,823			1,905
Cardiovascular/metabolic		5,500			5,130
Intal®		1,903	15		1,392
Other Hospital/acute care		3,416			2,212

Hospital/acute care		5,319			3,604
Skelaxin®		3,887	13.5		3,887
Sonata®					1,566
Neuroscience		3,887			5,453
Other		2,038			1,948
Total Branded		16,744			16,135
Meridian Medical Technologies		1,933			1,291
Royalties		10			11
Contract manufacturing					
All other					
Total trademarks and product rights	$	$ 18,687		$	$ 17,437

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The amounts for impairments and amortization expense and the amortization period used for the nine months ended September 30, 2006 and 2005 are as follows:

	Nine Months Ended September 30, 2006			Nine Months Ended September 30, 2005	
	Impairments	Amortization Expense	Life (Years)	Impairments	Amortization Expense
	(In thousands)			(In thousands)	
Branded					
Altace®	$	$ 11,032	21	$	$ 9,675
Other Cardiovascular/metabolic		5,468			5,687
Cardiovascular/metabolic		16,500			15,362
Intal®		5,708	15		4,144
Other Hospital/acute care	279	10,219			6,638
Hospital/acute care	279	15,927			10,782
Skelaxin®		11,661	13.5		11,661
Sonata®				126,923	7,551
Neuroscience		11,661		126,923	19,212
Other		6,159			5,903
Total Branded	279	50,247		126,923	51,259
Meridian Medical Technologies		5,330			3,873
Royalties		31			32
Contract manufacturing					
All other					
Total trademark and product rights	$ 279	$ 55,608		$ 126,923	$ 55,164

The remaining patent amortization period and the remaining amortization period for trademarks and product rights associated with significant products are as follows:

	Remaining Life at September 30, 2006	
	Patent	Trademark & Product Rights
Altace®	2 years 7 months	13 years 3 months
Skelaxin®		10 years 3 months
Sonata®	3 months	
Intal®		11 years 3 months

Inventories. Our inventories are valued at the lower of cost or market value. Cost is determined using the first-in, first-out (FIFO) method. We include in our inventories an allocation of fixed production overhead costs

which primarily consist of personnel costs and property taxes. We expense a portion of our fixed overhead costs associated with any facility operating at a level considered to be below normal capacity. We evaluate our entire inventory for short dated or slow moving product and inventory commitments under supply agreements based on projections of future demand and market conditions. For those units in inventory that are so identified, we estimate their market value or net sales value based on current realization trends. If the projected net realizable value is less than cost, on a product basis, we make a provision to reflect the lower value of that inventory. This methodology recognizes projected inventory losses at the time such losses are evident rather than at the time goods are actually sold. We maintain supply agreements with some of our vendors which contain minimum purchase requirements. We estimate future inventory requirements based on current facts and trends. Should our minimum purchase requirements under supply agreements or our estimated future inventory requirements exceed actual inventory quantities that we will be able to sell to our customers, we record a charge in costs of revenues.

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Accruals for rebates, returns, and chargebacks. We establish accruals for returns, chargebacks and Medicaid, Medicare, and commercial rebates in the same period we recognize the related sales. The accruals reduce revenues and are included in accrued expenses. At the time a rebate or chargeback payment is made or a product return is received, which occurs with a delay after the related sale, we record a reduction to accrued expenses and, at the end of each quarter, adjust accrued expenses for differences between estimated and actual payments. Due to estimates and assumptions inherent in determining the amount of returns, chargebacks and rebates, the actual amount of product returns and claims for chargebacks and rebates may be different from our estimates.

Our product returns accrual is primarily based on estimates of future product returns over the period during which customers have a right of return which is in turn based in part on estimates of the remaining shelf life of our products when sold to customers. Future product returns are estimated primarily on historical sales and return rates. We also consider the level of inventory of our products in the distribution channel. We base our estimate of our Medicaid rebate, Medicare rebate, and commercial rebate accruals on estimates of usage by rebate-eligible customers, estimates of the level of inventory of our products in the distribution channel that remain potentially subject to those rebates, and the terms of our commercial and regulatory rebate obligations. We base our estimate of our chargeback accrual on our estimates of the level of inventory of our products in the distribution channel that remain subject to chargebacks, and specific contractual and historical chargeback rates. The estimate of the level of our products in the distribution channel is based on data provided by our wholesale customers under inventory management agreements, including our three key wholesale customers.

Our accruals for returns, chargebacks and rebates are adjusted as appropriate for specific known developments that may result in a change in our product returns or our rebate and chargeback obligations. In the case of product returns, we monitor demand levels for our products and the effects of the introduction of competing products and other factors on this demand. When we identify decreases in demand for products or experience higher than historical rates of returns caused by unexpected discrete events, we further analyze these products for potential additional supplemental reserves.

Revenue recognition. Revenue is recognized when title and risk of loss are transferred to customers, collection of sales is reasonably assured, and we have no further performance obligations. This is generally at the time products are received by the customer. Accruals for estimated returns, rebates and chargebacks, determined based on historical experience, reduce revenues at the time of sale and are included in accrued expenses. Medicaid and certain other governmental pricing programs involve particularly difficult interpretations of relevant statutes and regulatory guidance, which are complex and, in certain respects, ambiguous. Moreover, prevailing interpretations of these statutes and guidance can change over time. Royalty revenue is recognized based on a percentage of sales (namely, contractually agreed-upon royalty rates) reported by third parties.

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RISK FACTORS

You should carefully consider the risks described below and the other information contained in this report, including our unaudited consolidated financial statements and related notes. You should also consider the information contained in our annual report on Form 10-K for the year ended December 31, 2005, including our audited consolidated financial statements and related notes. The risks described below are not the only ones facing our company. Additional risks not presently known to us or that we currently deem immaterial may also impair our business operations. If any of the adverse events described in this Risk Factors section or other sections of this report or our annual report on Form 10-K for the year ended December 31, 2005 actually occurs, our business, results of operations and financial condition could be materially adversely affected, the trading price, if any, of our securities could decline and you might lose all or part of your investment.

Risks Related to our Business

If we cannot successfully enforce our rights under the patents relating to three of our largest products, Altace®, Skelaxin® and Sonata®, and the patent relating to Adenoscan®, or if we are unable to secure or enforce our rights under other patents, trademarks, trade secrets or other intellectual property, our results of operations could be materially adversely affected.

Cobalt Pharmaceuticals, Inc. (Cobalt), a generic drug manufacturer located in Mississauga, Ontario, Canada, filed an ANDA with the FDA seeking permission to market a generic version of Altace®. The following U.S. patents are listed for Altace® in the FDA s *Approved Drug Products with Therapeutic Equivalence Evaluations*, which is known as the Orange Book : United States Patent No. 5,061,722 (the 722 patent), a composition-of-matter patent, and United States Patent No. 5,403,856 (the 856 patent), a method-of-use patent, with expiration dates of October 2008 and April 2012, respectively. Under the Hatch-Waxman Act, any generic manufacturer may file an ANDA with a certification, known as a Paragraph IV certification, challenging the validity or infringement of a patent listed in the FDA s Orange Book four years after the pioneer company obtains approval of its NDA. Cobalt filed a Paragraph IV certification alleging invalidity of the 722 patent, and Aventis Pharma Deutschland GmbH (Aventis) and the Company filed suit on March 14, 2003, in the District Court for the District of Massachusetts to enforce our rights under that patent. Pursuant to the Hatch-Waxman Act, our filing of that suit provided us an automatic stay of FDA approval of Cobalt s ANDA for 30 months (unless the patents are held invalid, unenforceable, or not infringed) from no earlier than February 5, 2003. That 30 month stay expired in August 2005 and on October 24, 2005, the FDA granted final approval of Cobalt s ANDA. In March 2004, Cobalt stipulated to infringement of the 722 patent. Subsequent to filing our original complaint, we amended our complaint to add an allegation of infringement of the 856 patent. The 856 patent covers one of Altace® s three indications for use. In response to the amended complaint, Cobalt informed the FDA that it no longer seeks approval to market its proposed product for the indication covered by the 856 patent. On this basis, the court granted Cobalt summary judgment of non-infringement of the 856 patent. The court s decision does not affect Cobalt s infringement of the 722 patent. The parties submitted a joint stipulation of dismissal on April 4, 2006, and the court granted dismissal.

We have received a request for information from the U.S. Federal Trade Commission (FTC) in connection with the dismissal without prejudice of our patent infringement litigation against Cobalt under the Hatch-Waxman Act of 1984. We are cooperating with the FTC in this investigation.

Lupin Ltd. (Lupin) filed an ANDA with the FDA seeking permission to market a generic version of Altace® (Lupin s ANDA). In addition to its ANDA, Lupin filed a Paragraph IV certification challenging the validity and infringement of the 722 patent, and seeking to market its generic version of Altace® before expiration of the 722 patent. In July 2005, we filed civil actions for infringement of the 722 patent against Lupin in the U.S. District Courts for the District of Maryland and the Eastern District of Virginia. Pursuant to the Hatch-Waxman Act, the filing of the suit against

Lupin provides us with an automatic stay of FDA approval of Lupin s ANDA for up to 30 months (unless the patents are held invalid, unenforceable, or not infringed) from no earlier than June 8, 2005. On February 1, 2006, the Maryland and Virginia cases were

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consolidated into a single action in the Eastern District of Virginia. On June 5, 2006, the Court granted us summary judgment and found Lupin to infringe the 722 patent. On June 14, 2006, during the trial, the Court dismissed Lupin s unenforceability claims as a matter of law, finding the 722 patent enforceable. On July 18, 2006, the validity of the 722 patent was upheld. Lupin filed a notice of appeal on July 19, 2006.

We intend to vigorously enforce our rights under the 722 and 856 patents. If a generic version of Altace® enters the market, our business, financial condition, results of operations and cash flows could be materially adversely affected. As of September 30, 2006, we had net intangible assets related to Altace® of $230.9 million. If a generic version of Altace® enters the market, the Company may have to write off a portion or all of the patent intangible assets and the other intangible assets associated with this product.

Eon Labs, Inc. (Eon Labs), CorePharma, LLC (CorePharma) and Mutual Pharmaceutical Co. (Mutual), Inc. have each filed an ANDA with the FDA seeking permission to market a generic version of Skelaxin® 400 mg tablets. Additionally, Eon Labs ANDA seeks permission to market a generic version of Skelaxin® 800 mg tablets. United States Patent Nos. 6,407,128 (the 128 patent) and 6,683,102 (the 102 patent), two method-of-use patents relating to Skelaxin®, are listed in the FDA s Orange Book and do not expire until December 3, 2021. Eon Labs and CorePharma have each filed Paragraph IV certifications against the 128 and 102 patents and are alleging noninfringement, invalidity and unenforceability of these patents. Mutual has filed a Paragraph IV certification against the 102 patent alleging noninfringement and invalidity of that patent. A patent infringement suit was filed against Eon Labs on January 2, 2003 in the District Court for the Eastern District of New York; against CorePharma on March 7, 2003 in the District Court for the District of New Jersey (subsequently transferred to the District Court for the Eastern District of New York); and against Mutual on March 12, 2004 in the District Court for the Eastern District of Pennsylvania concerning their proposed 400 mg products. Additionally, we filed a separate suit against Eon Labs on December 17, 2004, in the District Court for the Eastern District of New York concerning its proposed 800 mg product. Pursuant to the Hatch-Waxman Act, the filing of the suit against CorePharma provided us with an automatic stay of FDA approval of CorePharma s ANDA for 30 months (unless the patents are held invalid, unenforceable, or not infringed) from no earlier than January 24, 2003. That 30 month stay expired in July 2005. Also pursuant to the Hatch-Waxman Act, the filing of the suits against Eon Labs provided us with an automatic stay of FDA approval of Eon Labs ANDA for its proposed 400 mg and 800 mg products for 30 months (unless the patents are held invalid, unenforceable, or not infringed) from no earlier than November 18, 2002 and November 3, 2004, respectively. The 30 month stay of FDA approval of Eon Labs ANDA for its proposed 400 mg product expired May 2005. On May 17, 2006, the District Court for the Eastern District of Pennsylvania placed the Mutual case on the Civil Suspense Calendar pending the outcome of the FDA activity described below. On June 16, 2006, the District Court for the Eastern District of New York consolidated the Eon Labs cases with the CorePharma case. We intend to vigorously enforce our rights under the 128 and 102 patents to the full extent of the law.

On March 9, 2004, we received a copy of a letter from the FDA to all ANDA applicants for Skelaxin® stating that the use listed in the FDA s Orange Book for the 128 patent may be deleted from the ANDA applicants product labeling. We believe that this decision is arbitrary, capricious, and inconsistent with the FDA s previous position on this issue. We filed a Citizen Petition on March 18, 2004 (supplemented on April 15, 2004 and on July 21, 2004), requesting the FDA to rescind that letter, require generic applicants to submit Paragraph IV certifications for the 128 patent, and prohibit the removal of information corresponding to the use listed in the Orange Book. We concurrently filed a Petition for Stay of Action requesting the FDA to stay approval of any generic metaxalone products until the FDA has fully evaluated our Citizen Petition.

On March 12, 2004, the FDA sent a letter to us explaining that our proposed labeling revision, which includes references to additional clinical studies relating to food, age, and gender effects, was approvable and only required certain formatting changes. On April 5, 2004, we submitted amended labeling text that incorporated those changes. On April 5, 2004, Mutual filed a Petition for Stay of Action requesting the FDA to stay approval of our proposed

labeling revision until the FDA has fully evaluated and ruled upon our Citizen Petition, as well as all comments submitted in response to that petition. Discussions with the FDA concerning appropriate labeling are ongoing. CorePharma, Mutual and we have filed responses and supplements to their pending Citizen Petitions and responses. On December 8, 2005, Mutual filed another

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supplement with the FDA in which it withdrew its prior Petition for Stay, supplement, and opposition to King s Citizen Petition.

If our Citizen Petition is rejected, there is a substantial likelihood that a generic version of Skelaxin® will enter the market, and our business, financial condition, results of operations and cash flows could be materially adversely affected. In an attempt to mitigate this risk, we have entered into an agreement with a generic pharmaceutical company to launch an authorized generic of Skelaxin® in the event of generic competition. However, we cannot provide any assurance regarding the degree to which this strategy will be successful, if at all. As of September 30, 2006, we had net intangible assets related to Skelaxin® of $158.7 million. If demand for Skelaxin® declines below current expectations, we may have to write off a portion or all of these intangible assets.

Sicor Pharmaceuticals, Inc. (Sicor), a generic drug manufacturer located in Irvine California, filed an ANDA with the FDA seeking permission to market a generic version of Adenoscan®. U.S. Patent No. 5,070,877 (the 877 patent) is assigned to us and is listed in the FDA s Orange Book entry for Adenoscan®. Astellas Pharma US, Inc. (Astellas) is the exclusive licensee of certain rights under the 877 and has marketed Adenoscan® in the U.S. since 1995. A substantial portion of the revenues from our royalties segment is derived from Astellas from its net sales of Adenoscan®. Sicor has filed a Paragraph IV certification alleging invalidity of the 877 patent and non-infringement of certain claims of the 877 patent. We and Astellas filed suit against Sicor and its parents/affiliates Sicor, Inc., Teva Pharmaceuticals USA, Inc. (Teva) and Teva Pharmaceutical Industries, Ltd., on May 26, 2005, in the United States District Court for the District of Delaware to enforce our rights under the 877 patent. Pursuant to the Hatch-Waxman Act, the filing of that suit provides us an automatic stay of FDA approval of Sicor s ANDA for 30 months (unless the patents are held invalid, unenforceable, or not infringed) from no earlier than April 16, 2005. On May 16, 2006, Sicor stipulated to infringement of the asserted claims of the 877 patent. Trial in this action is currently scheduled to begin on February 12, 2007. We intend to vigorously enforce our rights under the 877 patent. If a generic version of Adenoscan® enters the market, our business, financial condition, results of operations and cash flows could be materially adversely affected.

Teva filed an ANDA with the FDA seeking permission to market a generic version of Sonata®. In addition to its ANDA, Teva filed a Paragraph IV certification challenging the validity and enforceability of U.S. Patent 4,626,538 (the 538 patent) listed in the Orange Book, a composition-of-matter patent which expires in June 2008. We filed suit against Teva in the United States District Court for the District of New Jersey to enforce our rights under the 538 patent. Pursuant to the Hatch-Waxman Act, our filing of that suit provides us an automatic stay of FDA approval of Teva s ANDA for 30 months (unless the patents are held invalid, unenforceable, or not infringed) from no earlier than June 21, 2005. On September 25, 2006, the parties filed a stipulation with the Court in which Teva admitted infringement of the 538 patent. We intend to vigorously enforce our rights under the 538 patent. As of September 30, 2006, we had net intangible assets related to Sonata® of $2.8 million. If a generic form of Sonata® enters the market, our business, financial condition, results of operations and cash flows could be materially adversely affected.

We may not be successful in securing or maintaining proprietary patent protection for other of our products or for products and technologies we develop or license. In addition, our competitors may develop products similar to ours, including generic products, using methods and technologies that are beyond the scope of our intellectual property protection, which could materially reduce our sales.

We also rely upon trade secrets, unpatented proprietary know-how and continuing technological innovation in order to maintain our competitive position. We cannot assure you that others will not independently develop substantially equivalent proprietary technology and techniques or otherwise gain access to our trade secrets and technology, or that we can adequately protect our trade secrets and technology.

If we are unable to secure or enforce patent rights, trademarks, trade secrets or other intellectual property, our business, financial condition, results of operations and cash flows could be materially adversely affected.

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The securities and derivative litigation or the continuing SEC investigation could have a material adverse effect on our business.

Subsequent to the announcement of the SEC investigation described in SEC Investigation included in Note 9, Contingencies, in Item 1, Financial Statements, beginning in March 2003, 22 purported class action complaints were filed by holders of our securities against us, our directors, former directors, our executive officers, former executive officers, a subsidiary, and a former director of the subsidiary in the United States District Court for the Eastern District of Tennessee, alleging violations of the Securities Act of 1933 and/or the Securities Exchange Act of 1934 in connection with our underpayment of rebates owed to Medicaid and other governmental pricing programs, and certain transactions between us and the Benevolent Fund, a non profit organization affiliated with certain former members of our senior management. These 22 complaints have been consolidated in the United States District Court for the Eastern District of Tennessee. In addition, holders of our securities filed two class action complaints alleging violations of the Securities Act of 1933 in Tennessee state court. We removed these two cases to the United States District Court for the Eastern District of Tennessee, where these two cases were consolidated with the other class actions. The district court has appointed lead plaintiffs in the consolidated action, and those lead plaintiffs filed a consolidated amended complaint on October 21, 2003, alleging that we, through some of our executive officers, former executive officers, directors, and former directors, made false or misleading statements concerning our business, financial condition, and results of operations during periods beginning February 16, 1999 and continuing until March 10, 2003. Plaintiffs in the consolidated action have also named the underwriters of our November 2001 public offering as defendants. We and other defendants filed motions to dismiss the consolidated amended complaint.

On August 12, 2004, the United States District Court for the Eastern District of Tennessee ruled on defendants motions to dismiss. The Court dismissed all claims as to Jones Pharma Incorporated, a predecessor to one of our wholly owned subsidiaries, King Pharmaceuticals Research and Development, Inc., and as to defendants Dennis Jones and Henry Richards. The Court also dismissed certain claims as to five other individual defendants. The Court denied the motions to dismiss in all other respects. Following the Court s ruling, on September 20, 2004, we and the other remaining defendants filed answers to plaintiffs consolidated amended complaint.

In November 2005, the parties agreed to submit the matter to non-binding mediation. After an extensive mediation process, an agreement in principle to settle the litigation was reached on April 26, 2006. On July 31, 2006, the parties entered into a stipulation of settlement and a supplemental agreement (together, the Settlement Agreement) to resolve the litigation. On September 27, 2006, the court granted preliminary approval of the Settlement Agreement. Consummation of the Settlement Agreement is still subject to certain conditions, including, among others, final court approval. The Settlement Agreement provides for a settlement amount of $38.3 million. Prior to the Settlement Agreement the Court established April 10, 2007 as the trial date.

We previously estimated a probable loss contingency of $38.3 million for the class action lawsuit described above. We believe all but an immaterial portion of this loss contingency will be paid on behalf of us by our insurance carriers. Accordingly, we previously recorded a liability and a receivable for this amount, which are classified in accrued expenses and prepaid and other current assets, respectively, in our consolidated financial statements.

Beginning in March 2003, four purported shareholder derivative complaints were also filed in Tennessee state court alleging a breach of fiduciary duty, among other things, by some of our current and former officers and directors, with respect to the same events at issue in the federal securities litigation described above. These cases have been consolidated, and on October 3, 2003, plaintiffs filed a consolidated amended complaint. On November 17, 2003, defendants filed a motion to dismiss or stay the consolidated amended complaint. The court denied the motion to dismiss, but granted a stay of proceedings. On October 11, 2004, the court lifted the stay to permit plaintiffs to file a further amended complaint adding class action claims related to our then-anticipated merger with Mylan Laboratories, Inc. On October 26, 2004, defendants filed a partial answer to the further amended complaint, and moved to dismiss

the newly-added claims. Following the termination of the Mylan merger agreement, plaintiffs voluntarily dismissed these claims. On October 11,

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2006, plaintiffs voluntarily dismissed Brian Markison and Elizabeth Greetham. Discovery with respect to the remaining claims in the case has commenced. No trial date has been set.

Beginning in March 2003, three purported shareholder derivative complaints were likewise filed in Tennessee federal court, asserting claims similar to those alleged in the state derivative litigation. These cases have been consolidated, and on December 2, 2003 plaintiffs filed a consolidated amended complaint. On March 9, 2004, the court entered an order indefinitely staying these cases in favor of the state derivative action.

In August 2004, a separate class action lawsuit was filed in Tennessee state court, asserting claims solely with respect to our then-anticipated merger with Mylan Laboratories. Defendants filed a motion to dismiss the case on November 30, 2004. On March 14, 2006, plaintiff voluntarily dismissed the case. On June 12, 2006, plaintiff filed a motion requesting an award of attorneys fees and expenses in the amount of $1.5 million. On October 18, 2006, plaintiffs modified their motion asking the court to determine whether plaintiffs are entitled to an award of reasonable attorneys fees and expenses. This motion is pending.

The SEC investigation of our previously disclosed errors relating to reserves for product returns is continuing, and it is possible that this investigation could result in the SEC s imposing fines or other sanctions on us.

During the third quarter of 2006, we recorded an anticipated insurance recovery of legal fees in the amount of $6.8 million for the class action and derivative suits described above. In November of 2006, we received payment for the recovery of these legal fees.

We are unable currently to predict the outcome or reasonably estimate the range of potential loss, if any, except as noted above, in the pending litigation. If we were not to prevail in the pending litigation, or if any governmental sanctions are imposed in excess of those described above, neither of which we can predict or reasonably estimate at this time, our business, financial condition, results of operations and cash flows could be materially adversely affected. Responding to the SEC investigation and defending us in the pending litigation has resulted, and could continue to result, in a significant diversion of management s attention and resources and is likely to require the payment of additional professional fees.

We have entered into agreements with manufacturers and/or distributors of generic pharmaceutical products with whom we are presently engaged, or have previously been engaged in litigation, and these agreements could subject us to claims that we have violated federal and/or state anti-trust laws.

We have negotiated and entered into a number of agreements with manufacturers and/or distributors of generic pharmaceutical products, some of whom are presently engaged or have previously been engaged in litigation with us. Governmental and/or private parties may allege that these arrangements and activities in furtherance of the success of these arrangements violate applicable state or federal anti-trust laws. Alternatively, courts could interpret these laws in a manner contrary to current understandings of such laws. If a court or other governmental body were to conclude that a violation of these laws had occurred, any liability based on such a finding could be material and adverse and could be preceded or followed by private litigation such as class action litigation.

We have received a request for information from the U.S. Federal Trade Commission (FTC) in connection with the dismissal without prejudice of our patent infringement litigation against Cobalt under the Hatch-Waxman Act of 1984. We are cooperating with the FTC in this investigation.

We cannot assure you that we will be able to comply with the terms and conditions of our corporate integrity agreement with the Office of Inspector General of the United States Department of Health and Human Services.

In October 2005, as part of our settlement of the government pricing investigation of our company Settlement of Governmental Pricing Investigation in Note 9, Contingencies, in Item 1, Financial Statements, we entered into a five-year corporate integrity agreement (CIA) with the Office of Inspector General of the United States Department of Health and Human Services (HHS/OIG). The purpose of the

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CIA, which applies to all of our U.S. subsidiaries and employees, is to promote compliance with the federal health care and procurement programs in which we participate, including the Medicaid Drug Rebate Program, the Medicare Program, the 340B Drug Pricing Program, and the Veterans Administration Pricing Program.

In addition to the challenges associated with complying with the regulations applicable to each of these programs (as discussed below), we are required, among other things, to keep in place our current compliance program, provide specified training to employees, retain an independent review organization to conduct periodic audits of our Medicaid Rebate calculations and our automated systems, processes, policies and practices related to government pricing calculations, and to provide periodic reports to HHS/OIG.

Implementing the broad array of processes, policies, and procedures necessary to comply with the CIA has required, and is expected to continue to require, a significant portion of management s attention as well as the application of significant resources.

Failing to meet the CIA obligations could have serious consequences for us including stipulated monetary penalties for each instance of non-compliance. In addition, flagrant or repeated violations of the CIA could result in our being excluded from participating in government health care programs, which could have a material adverse effect on our business.

We are subject to the risk of additional litigation and regulatory proceedings or actions in connection with the restatement of prior period financial statements.

We previously restated our previously issued financial statements for the fiscal years 2002 and 2003, including interim periods in 2003, and the first two quarters of 2004. We may in the future be subject to class action suits, other litigation or regulatory proceedings or actions arising in relation to the restatement of our prior period financial statements. Any expenses incurred in connection with such a potential litigation or regulatory proceeding or action not covered by available insurance or any adverse resolution of this potential litigation or regulatory proceeding or action could have a material adverse effect on our business, results of operations, cash flows and financial condition. Further, any litigation or regulatory proceeding or action may be time-consuming and may distract our management from the conduct of our business.

We cannot assure you that we will be able to maintain effective internal control over financial reporting.

Under Section 404 of the Sarbanes-Oxley Act of 2002 and the rules issued thereunder, management is required to conduct an evaluation of the effectiveness of our internal control over financial reporting as of each year-end. We are also required to include in our Annual Reports on Form 10-K a report on management s assessment of the effectiveness of our internal control over financial reporting. Our registered public accounting firm also issues an audit report on management s assessment and our internal control over financial reporting.

Management has concluded that our internal control over financial reporting was effective as of December 31, 2005 and that it provided reasonable assurance regarding the reliability of our financial reporting and the preparation of our financial statements in accordance with generally accepted accounting principles. We cannot assure you that management will not identify one or more significant deficiencies or material weaknesses in our internal control over financial reporting during 2006 or thereafter, that the steps we take to address any significant deficiencies or material weaknesses will be successful, that a significant deficiency or material weakness will not result in material errors in our financial statements before it is remediated, that management will be able to complete its assessment of internal control over financial reporting in a timely fashion in 2006 or thereafter, or that management will be able to conclude on the basis of its evaluation that our internal control over financial reporting is effective as of the end of 2006 or a later period.

If we fail to maintain effective internal control over financial reporting, including adapting this control to changing conditions and requirements, such a failure could have a material adverse effect on our business and the value of our common stock.

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If sales of our major products or royalty payments to us decrease, our results of operations could be materially adversely affected.

Altace®, Skelaxin®, Thrombin-JMI®, Levoxyl®, Sonata® and royalty revenues for the last twelve months ended September 30, 2006 accounted for 32.7%, 19.6%, 12.7%, 5.6%, 4.7% and 4.1% of our total revenues from continuing operations, respectively, or 79.4% in total. We believe that these sources of revenue may constitute a significant portion of our revenues for the foreseeable future. However, the agreements associated with some sources of royalty income may be terminated upon short notice and without cause or may be subject to substantial competition in the near future. Accordingly, any factor adversely affecting sales of any of these products or products for which we receive royalty payments could have a material adverse effect on our business, financial condition, results of operations and cash flows.

Although we have an obligation to indemnify our officers and directors, we may not have sufficient insurance coverage available for this purpose and may be forced to pay these indemnification costs directly. We may not be able to maintain existing levels of coverage, which could make it difficult to attract or retain qualified directors and officers.

Our charter and bylaws require that we indemnify our directors and officers to the fullest extent provided by applicable Tennessee law. Although we have purchased liability insurance for our directors and officers to fund such obligations, if our insurance carrier should deny coverage, or if the indemnification costs exceed the insurance coverage, we would be forced to bear some or all of these indemnification costs directly, which could be substantial and may have a material adverse effect on our business, financial condition, results of operations and cash flows. If the cost of this insurance increases significantly, or if this insurance becomes unavailable, we may not be able to increase or maintain our levels of insurance coverage for our directors and officers, which could make it difficult to attract or retain qualified directors and officers.

We are required annually, or on an interim basis as needed, to review the carrying value of our intangible assets and goodwill for impairment. If events such as generic competition or inability to manufacture or obtain sufficient supply of product occur that cause the sales of our products to decline, the intangible asset value of any declining product could become impaired.

As of September 30, 2006, we had approximately $1.0 billion of net intangible assets and goodwill. Intangible assets primarily include the net book value of various product rights, trademarks, patents and other intangible rights. If a change in circumstances causes us to lower our future sales forecast for a product, we may be required to write off a portion of the net book value of the intangible assets associated with that product. Any impairment of the net book value of any product or combination of products, depending on the size of the product or products, could result in a material adverse effect on our business, financial condition and results of operations. In evaluating goodwill for impairment, we estimate the fair value of our individual business reporting units on a discounted cash flow basis. In the event the value of an individual business reporting unit declines significantly, it could result in a non-cash impairment charge.

If we cannot implement our strategy to grow our business through increased sales, acquisitions, development and in-licensing, our business or competitive position in the pharmaceutical industry may suffer.

Our current strategy is to increase sales of our existing products and to enhance our competitive standing through acquisitions or in-licensing of products, either in development or previously approved by the FDA, that complement our business and enable us to promote and sell new products through existing marketing and distribution channels. Moreover, since we engage in limited proprietary research activity with respect to the development of new chemical entities, we rely heavily on purchasing or licensing products in development and FDA-approved products from other

companies.

Development projects, including those in which we have collaboration agreements with third parties, include the following:

Remoxy™, an investigational drug for the treatment of moderate-to-severe chronic pain;

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binodenoson, a myocardial pharmacologic stress imaging agent;

Vanquix™, a diazepam-filled auto-injector;

bremelanotide, (which we previously referred to as PT-141), an investigational new drug for the treatment of erectile dysfunction and female sexual dysfunction;

MRE0094, an investigational drug for the topical treatment of chronic diabetic foot ulcers;

T-62, an investigational drug for the treatment of neuropathic pain;

a new inhaler for Intal® using the alternative propellant hydrofluoroalkane (HFA) for which the FDA has issued an approvable letter;

a potential new formulation of metaxalone;

a novel formulation of ramipril for which an NDA is pending;

an Altace®/diuretic combination product; and

a program to evaluate the safety and efficacy of Altace® in children.

We compete with other pharmaceutical companies, including large pharmaceutical companies with financial, human and other resources substantially greater than ours, in the development and licensing of new products. We cannot assure you that we will be able to

engage in product life-cycle management to develop new indications and line extensions for existing and acquired products,

successfully develop, license or commercialize new products on a timely basis or at all,

continue to develop products already in development in a cost effective manner, or

obtain any FDA approvals necessary to successfully implement the strategies described above.

If we are not successful in the development or licensing of new products already in development, including obtaining any necessary FDA approvals, our business, financial condition, and results of operations could be materially adversely affected.

Further, other companies may license or develop products or may acquire technologies for the development of products that are the same as or similar to the products we have in development or that we license. Because there is rapid technological change in the industry and because many other companies may have more financial resources than we do, other companies may

develop or license their products more rapidly than we can,

complete any applicable regulatory approval process sooner than we can,

market or license their products before we can market or license our products, or

offer their newly developed or licensed products at prices lower than our prices,

and thereby have a negative impact on the sales of our existing, newly developed or licensed products. The inability to effect acquisitions or licenses of additional branded products in development and FDA-approved products could limit the overall growth of our business. Furthermore, even if we obtain rights to a pharmaceutical product or acquire a company, we may not be able to generate sales sufficient to create a profit or otherwise avoid a loss. Technological developments or the FDA s approval of new products or of new therapeutic indications for existing products may make our existing products or those products we are licensing or developing obsolete or may make them more difficult to market successfully, which could have a material adverse effect on our business, financial condition, results of operations and cash flows.

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If we cannot integrate the business of companies or products we acquire, or appropriately and successfully manage and coordinate third-party collaborative development activities, our business may suffer.

The integration into our business of in-licensed or acquired assets or businesses, as well as the coordination and collaboration of development, sales and marketing efforts with third parties, requires significant management attention and may require the further expansion of our support personnel, sales force and other human resources. In order to manage our in-license and acquisition activity effectively, we must maintain adequate operational, financial and management information systems, integrate the systems that we acquire into our existing systems, and ensure that the acquired systems meet our standards for internal control over financial reporting. Our future success will also depend in part on our ability to hire, retain and motivate qualified employees to manage expanded operations efficiently and in accordance with applicable regulatory standards. If we cannot manage our third-party collaborations and integrate in-licensed and acquired assets successfully, or, if we do not establish and maintain an appropriate administrative, support and control infrastructure to support these activities, this could have a material adverse effect on our business, financial condition, results of operations and cash flows and on our ability to make the necessary certifications with respect to our internal controls.

We do not have proprietary protection for most of our branded pharmaceutical products, and our sales could suffer from competition by generic substitutes.

Although most of our revenue is generated by products not subject to competition from generic products, there is no proprietary protection for most of our branded pharmaceutical products, and generic substitutes for many of these products are sold by other pharmaceutical companies. Even our products that currently have no generic substitute could face generic competition if generics are developed by other companies and approved by the FDA. The entry of generic substitutes for any of our products could adversely affect our business, financial condition, results of operations and cash flows. In addition, governmental and other pressure to reduce pharmaceutical costs may result in physicians prescribing products for which there are generic substitutes. Also, our branded products for which there is no generic form available may face competition from different therapeutic agents used for the same indications for which our branded products are used. Increased competition from the sale of generic pharmaceutical products or from different therapeutic agents used for the same indications for which our branded products are used may cause a decrease in revenue from our branded products and could have a material adverse effect on our business, financial condition, results of operations and cash flows.

If we cannot sell our products in amounts greater than our minimum purchase requirements under some of our supply agreements or sell our products in accordance with our forecasts, our results of operations and cash flows may be adversely affected.

Some of our supply agreements or purchase orders, including those related to Altace® and Skelaxin®, require us to purchase certain minimum levels of active ingredients or finished goods. If we are unable to maintain market exclusivity for our products, if our product life-cycle management is not successful, or if we fail to sell our products in accordance with the forecasts we develop as required by our supply agreements, we may incur losses in connection with the purchase commitments under the supply agreements or purchase orders. In the event we incur losses in connection with the purchase commitments under our supply agreements or purchase orders, there may be a material adverse effect upon our results of operations and cash flows.

Additionally, we purchase raw materials and some of our finished goods based on our forecast for sales of our products. We also manufacture many of our finished goods based on these forecasts. If we do not meet expected forecasts for sales, we could purchase inventory quantities in excess of expected demand. This purchase of excess inventory could have a material adverse effect on our results of operations and cash flows.

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Any significant delays or difficulties in the manufacture of, or supply of materials for, our products may reduce our profit margins and revenues, limit the sales of our products, or harm our products reputations.

We manufacture or jointly manufacture with third parties many of our products in facilities we own and operate. These products include Altace®, Thrombin-JMI® and Levoxyl®, which together represented approximately 51.0% of our revenues for the twelve months ended September 30, 2006. Many of our production processes are complex and require specialized and expensive equipment. In addition, we are transferring the production of Levoxyl® from our St. Petersburg, Florida facility to our Bristol, Tennessee facility. If we are not in compliance with applicable regulations, or if we experience delays in obtaining regulatory authorizations or experience production difficulties, the manufacture of our products could be delayed, halted or otherwise adversely affected. Any unforeseen delays or interruptions in our manufacturing operations may reduce our profit margins and revenues. In the event of an interruption, we may not be able to distribute our products as planned. Furthermore, demand for our products could exceed our ability to supply the demand. If such situations occur, it may be necessary for us to seek alternative manufacturers, which could adversely affect our ability to produce and distribute our products. We cannot assure you that we would be able to arrange for third parties to manufacture our products in a timely manner or at all. In addition, our manufacturing output may be interrupted by power outages, supply shortages, accidents, natural disasters or other disruptions. Even though we carry business interruption insurance policies, we may suffer losses as a result of business interruptions that exceed the coverage available under our insurance policies.

Many of our product lines, including Altace®, Skelaxin®, Sonata®, Intal®, Tilade®, Synercid® and Cortisporin®, are currently manufactured in part or entirely by third parties. Our dependence upon third parties for the manufacture of our products may adversely affect our profit margins or may result in unforeseen delays or other problems beyond our control. For example, if any of these third parties are not in compliance with applicable regulations, the manufacture of our products could be delayed, halted or otherwise adversely affected. If for any reason we are unable to obtain or retain third-party manufacturers on commercially acceptable terms, we may not be able to distribute our products as planned. If we encounter delays or difficulties with contract manufacturers in producing or packaging our products, the distribution, marketing and subsequent sales of these products could be adversely affected, and we may have to seek alternative sources of supply or abandon or sell product lines on unsatisfactory terms. We might not be able to enter into alternative supply arrangements at commercially acceptable rates, if at all. We also cannot assure you that the manufacturers we use will be able to provide us with sufficient quantities of our products or that the products supplied to us will meet our specifications.

We have nearly completed construction of facilities to produce Bicillin® at our Rochester, Michigan location. The third-party manufacturer that produced Bicillin® for us closed its plant. If our inventory of Bicillin® is not sufficient to sustain demand while we are constructing our Bicillin® manufacturing facility, or if we experience delays in obtaining regulatory authorizations or experience production difficulties at our Bicillin® manufacturing facility, sales of this product may be reduced or the market for the product may be permanently diminished, either of which could have a material adverse effect on our business, financial condition, results of operations and cash flows. For the last twelve months ended September 30, 2006, net sales of Bicillin® were $44.5 million, representing 2.3% of our total revenues.

We are also in the process of transferring the manufacture of some of our other products that are currently manufactured by third parties to our manufacturing facilities. We expect to complete these transfers prior to the expiration of the agreements concerning supply of these products. However, we cannot assure you that we will complete the transfers prior to the expiration of the supply agreements, which could have a material adverse effect on our business, financial condition, results of operations and cash flows.

We and third parties with whom we contract require a supply of quality raw materials and components to manufacture and package our pharmaceutical products. Currently, we and our third-party manufacturers rely on over 500 suppliers to deliver the necessary raw materials and components. Some of our contracts for the supply of raw materials have

short durations, and there is no assurance that we will be able to secure extension of the terms of such agreements. If we or our third-party manufacturers are unable to obtain sufficient

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quantities of any of the raw materials or components required to produce and package our products, we may not be able to distribute our products as planned.

The occurrence of any of these events could result in significant backorders for our products, which could have a material adverse effect on our business, financial condition, results of operations and cash flows and could adversely affect our market share for the products and the reputation of our products.

If third-party developers of some of our new product candidates and reformulated products fail to devote sufficient time and resources to our concerns, or if their performance is substandard or otherwise fails to comply with the terms of their agreements with us, or if we mismanage the development process, the introduction of new or reformulated products may not be successful.

We develop and manage the development of products and product line extensions through research and development and through contractual relationships with third parties that develop new products, including new product formulations, on our behalf. Our reliance on third parties for the development of some of our products exposes us to risks which could cause delays in the development of new products or reformulated products or could cause other problems beyond our control. These third-party developers

- may not be successful in developing the products or product line extensions for us,
- may face financial or business related difficulties which could make it difficult or impossible for them to continue business operations, or
- may otherwise breach or terminate their agreements with us.

If any of these events occurs, or we mismanage these processes or the third parties who perform services on our behalf, and we are unable to successfully develop these products and new product formulations by other means, our business, financial condition, results of operations and cash flows could be materially and adversely affected.

We are near maximum capacity at our Middleton, Wisconsin facility, which limits our ability to increase production of Thrombin-JMI®.

We are currently working to expand our production capacity for Thrombin-JMI®. We cannot assure you that our plans to expand our production capacity for Thrombin-JMI® will be successful and/or timely. If we cannot successfully and timely expand our production capacity for Thrombin-JMI®, our ability to increase production of Thrombin-JMI® will be limited, which could in turn limit our unit sales growth for this product.

Wholesaler and distributor buying patterns and other factors may cause our quarterly results to fluctuate, and these fluctuations may adversely affect our short-term profitability.

Our results of operations, including, in particular, product sales revenue, may vary from quarter to quarter due to many factors. Sales to wholesalers and distributors represent a substantial portion of our total sales. Buying patterns of our wholesalers and distributors may vary from time to time. In the event wholesalers and distributors with whom we do business determine to limit their purchases of our products, sales of our products could be adversely affected. For example, in advance of an anticipated price increase, customers may order pharmaceutical products in larger than normal quantities. The ordering of excess quantities in any quarter could cause sales of some of our branded pharmaceutical products to be lower in subsequent quarters than they would have been otherwise. As part of our ongoing efforts to facilitate improved management of wholesale inventory levels of our branded pharmaceutical products, we have entered into inventory management and data services agreements with each of our three key

wholesale customers. These agreements provide wholesalers incentives to manage inventory levels and provide timely and accurate data with respect to inventory levels held, and valuable data regarding sales and marketplace activity. We rely on the timeliness and accuracy of the data that each customer provides to us on a regular basis pursuant to these agreements. If our wholesalers fail to provide us with timely and accurate data in accordance with the agreements, our estimates for certain reserves included in our financial statements could be materially and adversely affected.

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Other factors that may affect quarterly results include expenditures related to the acquisition, sale and promotion of pharmaceutical products, a changing customer base, the availability and cost of raw materials, interruptions in supply by third-party manufacturers, new products introduced by us or our competitors, the mix of products we sell, sales and marketing expenditures, product recalls, competitive pricing pressures and general economic and industry conditions that may affect customer demand. We cannot assure you that we will be successful in maintaining or improving our profitability or avoiding losses in any future period.

The insolvency of any of our principal customers, who are wholesale pharmaceutical distributors, could have a material adverse effect on our business, financial condition, results of operations and cash flows.

Similar to other pharmaceutical companies, our principal customers are primarily wholesale pharmaceutical distributors. The wholesale distributor network for pharmaceutical products has in recent years been subject to increasing consolidation, which has increased our, and other industry participants , customer concentration. Accordingly, three key customers accounted for approximately 69% of our gross sales and a significant portion of our accounts receivable for the fiscal year ended December 31, 2005. The insolvency of any of our principal customers could have a material adverse effect on our business, financial condition, results of operations and cash flows.

Our wholly owned subsidiary, King Pharmaceuticals Research and Development, Inc., successor to Jones Pharma Incorporated, is a defendant in litigation which is currently being handled by its insurance carriers. Should this coverage be inadequate or subsequently denied or were we to lose some of these lawsuits, our results of operations could be adversely affected.

Many distributors, marketers and manufacturers of anorexigenic drugs have been subject to claims relating to the use of these drugs. Generally, the lawsuits allege that the defendants (1) misled users of the products with respect to the dangers associated with them, (2) failed to adequately test the products and (3) knew or should have known about the negative effects of the drugs, and should have informed the public about the risks of such negative effects. Claims include product liability, breach of warranty, misrepresentation and negligence. The actions have been filed in various state and federal jurisdictions throughout the United States. A multi-district litigation (MDL) court has been established in Philadelphia, Pennsylvania, *In re* Fen-Phen Litigation. They seek, among other things, compensatory and punitive damages and/or court-supervised medical monitoring of persons who have ingested the product.

Our wholly-owned subsidiary King Pharmaceuticals Research and Development, Inc. (King Research and Development) is a defendant in approximately 140 multi-plaintiff (1,674 plaintiffs) lawsuits involving the manufacture and sale of dexfenfluramine, fenfluramine and phentermine. These lawsuits have been filed in various jurisdictions throughout the United States and in each of these lawsuits King Research and Development, as the successor to Jones Pharma, Inc. (Jones), is one of many defendants, including manufacturers and other distributors of these drugs. Although Jones did not at any time manufacture dexfenfluramine, fenfluramine, or phentermine, Jones was a distributor of a generic phentermine product and, after its acquisition of Abana Pharmaceuticals, was a distributor of Obenix®, Abana s branded phentermine product. The manufacturer of the phentermine purchased by Jones has filed for bankruptcy protection and is no longer in business. The plaintiffs in these cases, in addition to the above, claim injury as a result of ingesting a combination of these weight-loss drugs and are seeking compensatory and punitive damages as well as medical care and court-supervised medical monitoring. The plaintiffs claim liability based on a variety of theories, including, but not limited to, product liability, strict liability, negligence, breach of warranty, fraud and misrepresentation.

King Research and Development denies any liability incident to the distribution of Obenix® or Jones generic phentermine product and intends to pursue all defenses available to it. King Research and Development s insurance carriers are currently defending King Research and Development in these lawsuits. The manufacturers of fenfluramine and dexfenfluramine have settled many of these cases. As a result of the manufacturers of the fenfluramine and

dexfenfluramine settlements, King Research and Development has routinely received voluntarily dismissals without the payment of settlement proceeds. In the event that King Research and Development s insurance coverage is inadequate to satisfy any resulting liability, King Research

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and Development will have to resume defense of these lawsuits and be responsible for the damages, if any, that are awarded against it.

While we cannot predict the outcome of these lawsuits, management believes that the claims against King Research and Development are without merit and intends to vigorously pursue all defenses available. We are unable to disclose an aggregate dollar amount of damages claimed because many of these complaints are multi-party suits and do not state specific damage amounts. Rather, these claims typically state damages as may be determined by the court or similar language and state no specific amount of damages against King Research and Development. Consequently, we cannot reasonably estimate possible losses related to the lawsuits.

Sales of Thrombin-JMI® may be affected by the perception of risks associated with some of the raw materials used in its manufacture; if we are unable to successfully develop purification procedures at our facilities that are in accordance with the FDA s expectations for biological products generally, the FDA could limit our ability to manufacture biological products at those facilities.

For the twelve months ended September 30, 2006, our product Thrombin-JMI® accounted for 12.7% of our total revenues from continuing operations. The source material for Thrombin-JMI® comes from bovine plasma and lung tissue which has been certified by the United States Department of Agriculture for use in the manufacture of pharmaceutical products. Bovine-sourced materials, particularly those from outside the United States, may be of some concern because of potential transmission of bovine spongiform encephalopathy, or BSE. However, we have taken precautions to minimize the risks of contamination from BSE in our source materials. Our principal precaution is the use of bovine materials only from FDA-approved sources in the United States. Accordingly, all source animals used in our production of Thrombin-JMI® are of United States origin. Additionally, source animals used in production of Thrombin-JMI® are generally less than 18 months of age (BSE has not been identified in animals less than 30 months of age).

We have two approved vendors as sources of supply of the bovine raw materials. Any interruption or delay in the supply of these materials could adversely affect the sales of Thrombin-JMI®. We will continue surveillance of the source and believe that the risk of BSE contamination in the source materials for Thrombin-JMI® is very low. While we believe that our procedures and those of our vendor for the supply, testing and handling of the bovine material comply with all federal, state, and local regulations, we cannot eliminate the risk of contamination or injury from these materials. There are high levels of global public concern about BSE. Physicians could determine not to administer Thrombin-JMI® because of the perceived risk, which could adversely affect our sales of the product. Any injuries resulting from BSE contamination could expose us to extensive liability. Also, there is currently no alternative to the bovine-sourced materials for Thrombin-JMI®. If public concern for the risk of BSE infection in the United States should increase, the manufacture and sale of Thrombin-JMI® and our business, financial condition, results of operations and cash flows could be materially and adversely affected.

The FDA expects manufacturers of biological products to have validated processes capable of removing extraneous viral contaminants to a high level of assurance. As a result, many manufacturers of biologics are currently engaged in developing procedures to remove potential extraneous viral contaminants from their products. We have developed and implemented appropriate processing steps to achieve maximum assurance for the removal of potential extraneous viral contaminants from Thrombin-JMI®, which does not include BSE because it is not a viral contaminant and we gained FDA approval for these processes.

A failure by Dey, L.P. to successfully market the EpiPen® auto-injector, or an increase in competition, could have a material adverse effect on our results of operations.

Dey, L.P. markets our EpiPen® auto-injector through a supply agreement with us that expires on December 31, 2015. Under the terms of the agreement, we grant Dey the exclusive right and license to market, distribute and sell EpiPen®, either directly or through subdistributors. A new competitive product entered the market in the third quarter of 2005. The new product, TwinJect® Auto-Injector (epinephrine) injection, is not a therapeutically equivalent product but has the same indications, same usage and the same route of delivery as

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EpiPen®. Users of EpiPen® would have to obtain a new prescription in order to substitute TwinJect®. The supply agreement with Dey includes minimum purchase requirements that are less than Dey s purchases in recent years. A failure by Dey to successfully market and distribute EpiPen® or an increase in competition could have a material adverse effect on our business, financial condition, results of operations and cash flows.

Our relationships with the U.S. Department of Defense and other government entities are subject to risks associated with doing business with the government.

All U.S. government contracts provide that they may be terminated for the convenience of the government as well as for default. Our Meridian Medical Technologies segment has pharmaceutical products that are presently sold primarily to the U.S. Department of Defense (DoD) under an Industrial Base Maintenance Contract (IBMC). The current IBMC expires in July 2007. Although we have reason to believe the DoD will renew the IBMC based on our relationship of many years, we cannot assure you that they will. In the event the DoD does not renew the IBMC, our business, financial condition, results of operations and cash flows could be materially adversely affected. Additionally, the unexpected termination of one or more of our significant government contracts could result in a material adverse effect on our business, financial condition, results of operations and cash flows. A surge capability provision allows for the coverage of defense mobilization requirements in the event of rapid military deployment. If this surge capability provision becomes operative, we may be required to devote more of our Meridian Medical Technologies segment manufacturing capacity to the production of products for the government, which could result in less manufacturing capacity being devoted to products in this segment with higher profit margins.

Our supply contracts with the DoD are subject to post-award audit and potential price determination. These audits may include a review of our performance on the contract, our pricing practices, our cost structure and our compliance with applicable laws, regulations and standards. Any costs found to be improperly allocated to a specific contract will not be reimbursed, while costs already reimbursed must be refunded. Therefore, a post-award audit or price redetermination could result in an adjustment to our revenues. From time to time the DoD makes claims for pricing adjustments with respect to completed contracts. If a government audit uncovers improper or illegal activities, we may be subject to civil and criminal penalties and administrative sanctions, including termination of contracts, forfeitures of profits, suspension of payments, fines and suspension or disqualification from doing business with the government.

Other risks involved in government sales include the unpredictability in funding for various government programs and the risks associated with changes in procurement policies and priorities. Reductions in defense budgets may result in reductions in our revenues. We also provide our nerve agent antidote auto-injectors to a number of state agencies and local communities for homeland defense against chemical agent terrorist attacks. Changes in governmental and agency procurement policies and priorities may also result in a reduction in government funding for programs involving our auto-injectors. A loss in government funding of these programs could have a material adverse effect on our business, financial condition, results of operations and cash flows.

If we fail to comply with our reporting and payment obligations under the Medicaid rebate program or other governmental pricing programs, we could be subject to additional reimbursements, penalties, sanctions and fines which could have a material adverse effect on our business.

Medicaid reporting and payment obligations are highly complex and in certain respects ambiguous. If we fail to comply with these obligations, we could be subject to additional reimbursements, penalties, sanctions and fines which could have a material adverse effect on our business.

Since 2003, we have implemented new information technology systems that are intended to significantly enhance the accuracy of our calculations for estimating amounts due under Medicaid and other governmental pricing programs; however, our processes for these calculations and the judgments involved in making these calculations will continue

to involve subjective decisions, and, as a result, these calculations will remain subject to the risk of errors.

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If our operations were disrupted by a natural disaster or other catastrophic event, our business could be harmed.

A natural disaster, cyber-attack, terrorist attack, or other catastrophic event could result in a significant interruption of our normal business operations and have a material adverse effect on our business, financial conditions, results of operations and cash flows.

For example, for efficiency, we rely upon a central distribution facility, located in Bristol, Tennessee. An interruption in operations at this facility could limit our ability to deliver our products to customers. Similarly, our business depends upon centralized electronic communication, analysis and recordkeeping systems. Damage to these systems could limit the normal operation of many aspects of our business, such as receipt and processing of orders, shipment of products to customers, internal communications and maintenance of financial and other records.

If we are unable to obtain approval of new HFA propellants for Intal® and Tilade®, our sales of these products could be adversely affected.

Under government regulations, chlorofluorocarbon compounds are being phased out because of environmental concerns. Our products Intal® and Tilade® currently use these compounds as propellants. The FDA has issued an approvable letter with respect to the new drug application, or NDA covering a new inhaler for Intal® using the alternative propellant HFA. The approvable letter provides that final approval of the NDA for Intal® HFA is subject to addressing certain FDA comments solely pertaining to the chemistry, manufacturing, and controls section of the NDA covering the product. In the event we cannot also obtain final approval for alternative propellants for Intal® and Tilade® before the final phase-out date for use of chlorofluorocarbon compounds or if we are unable to maintain an adequate supply of chlorofluorocarbon compounds for the production of these products prior to this date, our ability to market these products could be materially adversely affected, which could have a material adverse effect on our business, financial condition, results of operations and cash flows.

There are risks associated with our restructured agreement with Wyeth regarding Altace®.

Our revenues depend significantly upon the sale of Altace®. We recently restructured our Co-Promotion Agreement with Wyeth regarding the promotion of Altace®. Previously, we and Wyeth each marketed Altace® and we paid Wyeth a co-promotion fee. Pursuant to the restructuring, effective January 1, 2007, we will assume full responsibility for the selling and marketing of Altace®. For the remainder of 2006, Wyeth will continue to promote Altace® with us, and will receive a reduced fee thereafter through 2010. Factors that may affect the success of the restructured arrangement include the following:

- our ability to sell and market Altace® effectively;
- the successful transition of Wyeth s marketing responsibilities to King during the remainder of 2006;
- the level of marketing and sales expenditures necessary to sell and market Altace® effectively; and
- Wyeth s continued commitment to sell and market Altace® for the remainder of 2006.

In the event we are not successful in the transition of Wyeth s marketing responsibilities to us or otherwise do not sell and market Altace® effectively, there may be a material adverse effect on our business, financial condition, results of operations and cash flows.

The loss of our key personnel or an inability to attract new personnel could harm our business.

We are highly dependent on the principal members of our management staff, the loss of whose services might impede the achievement of our strategic objectives. We cannot assure you that we will be able to attract and retain key personnel in sufficient numbers, or on acceptable terms, or with the skills which are necessary to support our growth and integration activities. The loss of the services of key personnel or the failure to attract such personnel could have a material adverse effect on us.

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Our shareholder rights plan, charter and bylaws discourage unsolicited takeover proposals and could prevent shareholders from realizing a premium on their common stock.

We have a shareholder rights plan that may have the effect of discouraging unsolicited takeover proposals. The rights issued under the shareholder rights plan would cause substantial dilution to a person or group which attempts to acquire us on terms not approved in advance by our Board of Directors. In addition, our charter and bylaws contain provisions that may discourage unsolicited takeover proposals that shareholders may consider to be in their best interests. These provisions include

a classified Board of Directors;

the ability of our Board of Directors to designate the terms of and issue new series of preferred stock;

advance notice requirements for nominations for election to our Board of Directors; and

special voting requirements for the amendment of our charter and bylaws.

We are also subject to anti-takeover provisions under Tennessee laws, each of which could delay or prevent a change of control. Together these provisions and the rights plan may discourage transactions that otherwise could involve payment of a premium over prevailing market prices for our common stock.

Our stock price is volatile, which could result in substantial losses for our investors.

The trading price of our common stock is volatile. The stock market in general and the market for the securities of emerging pharmaceutical companies such as King, in particular, have experienced extreme volatility. Many factors contribute to this volatility, including

variations in our results of operations;

perceived risks and uncertainties concerning our business;

announcements of earnings;

developments in the governmental investigations or securities litigation;

the commencement of, or adverse developments in, any material litigation;

failure to meet or exceed our own projections for revenue, product sales and earnings per share;

failure to meet timelines for product development or other projections or forward-looking statements we may make to the public;

failure to meet or exceed security analysts financial projections for our company;

comments or recommendations made by securities analysts;

general market conditions;

perceptions about market conditions in the pharmaceutical industry;

announcements of technological innovations or the results of clinical trials or studies;

changes in marketing, product pricing and sales strategies or development of new products by us or our competitors;

changes in domestic or foreign governmental regulations or regulatory approval processes; and

announcements concerning regulatory compliance and government agency reviews.

The volatility of our common stock imposes a greater risk of capital losses on our shareholders than would a less volatile stock. In addition, such volatility makes it difficult to ascribe a stable valuation to a shareholder s holdings of our common stock.

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Risks Related to Our Industry

Failure to comply with laws and government regulations could adversely affect our ability to operate our business.

Virtually all aspects of our activities are regulated by federal and state statutes and government agencies. The manufacturing, processing, formulation, packaging, labeling, distribution and advertising of our products, and disposal of waste products arising from these activities, are subject to regulation by one or more federal agencies, including the FDA, the Drug Enforcement Agency, which we refer to as the DEA, the Federal Trade Commission, the Consumer Product Safety Commission, the U.S. Department of Agriculture, the Occupational Safety and Health Administration, and the Environmental Protection Agency (EPA,), as well as by foreign governments in countries where we distribute some of our products.

Noncompliance with applicable FDA policies or requirements could subject us to enforcement actions, such as suspensions of manufacturing or distribution, seizure of products, product recalls, fines, criminal penalties, injunctions, failure to approve pending drug product applications or withdrawal of product marketing approvals. Similar civil or criminal penalties could be imposed by other government agencies, such as the DEA, the EPA or various agencies of the states and localities in which our products are manufactured, sold or distributed, and could have ramifications for our contracts with government agencies such as the Department of Veterans Affairs or the Department of Defense. These enforcement actions could have a material adverse effect on our business, financial condition, results of operations and cash flows.

All manufacturers of human pharmaceutical products are subject to regulation by the FDA under the authority of the Food, Drug and Cosmetics Act (the FDC Act), or the Public Health Service Act (the PHS Act), or both. New drugs, as defined in the FDC Act, and new human biological drugs, as defined in the PHS Act, must be the subject of an FDA-approved new drug or biologic license application before they may be marketed in the United States. Some prescription and other drugs are not the subject of an approved marketing application but, rather, are marketed subject to the FDA s regulatory discretion and/or enforcement policies. Any change in the FDA s enforcement discretion and/or policies could have a material adverse effect on our business, financial condition, results of operations and cash flows.

We manufacture some pharmaceutical products containing controlled substances and, therefore, are also subject to statutes and regulations enforced by the DEA and similar state agencies which impose security, record keeping, reporting and personnel requirements on us. Additionally, we manufacture biological drug products for human use and are subject to regulatory obligations as a result of these aspects of our business. There are additional FDA and other regulatory policies and requirements covering issues, such as advertising, commercially distributing, selling, sampling and reporting adverse events associated with our products, with which we must continuously comply. Noncompliance with any of these policies or requirements could result in enforcement actions which could have a material adverse effect on our business, financial condition, results of operations and cash flows.

The FDA has the authority and discretion to withdraw existing marketing approvals and to review the regulatory status of marketed products at any time. For example, the FDA may require withdrawal of an approved marketing application for any drug product marketed if new information reveals questions about a drug s safety or efficacy. All drugs must be manufactured in conformity with current Good Manufacturing Practices and drug products subject to an approved application must be manufactured, processed, packaged, held and labeled in accordance with information contained in the approved application.

While we believe that all of our currently marketed pharmaceutical products comply with FDA enforcement policies, have approval pending or have received the requisite agency approvals, our marketing is subject to challenge by the FDA at any time. Through various enforcement mechanisms, the FDA can ensure that noncomplying drugs are no

longer marketed and that advertising and marketing materials and campaigns are in compliance with FDA regulations. In addition, modifications, enhancements, or changes in manufacturing sites of approved products are in many circumstances subject to additional FDA approvals which may or may not be received and which may be subject to a lengthy FDA review process. Our manufacturing facilities and those of our third-party manufacturers are continually subject to inspection by governmental agencies.

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Manufacturing operations could be interrupted or halted in any of those facilities if a government or regulatory authority is unsatisfied with the results of an inspection. Any interruptions of this type could have a material adverse effect on our business, financial condition, results of operations and cash flows.

Under the Comprehensive Environmental Response, Compensation, and Liability Act, which we refer to as CERCLA, the EPA can impose liability for the entire cost of cleanup of contaminated properties upon each or any of the current and former site owners, site operators or parties who sent waste to the site, regardless of fault or the legality of the original disposal activity. In addition, many states, including Tennessee, Michigan, Wisconsin, Florida and Missouri, have statutes and regulatory authorities similar to CERCLA and to the EPA. We have entered into hazardous waste hauling agreements with licensed third parties to properly dispose of hazardous wastes. We cannot assure you that we will not be found liable under CERCLA or other applicable state statutes or regulations for the costs of undertaking a cleanup at a site to which our wastes were transported.

We cannot determine what effect changes in regulations, enforcement positions, statutes or legal interpretations, when and if promulgated, adopted or enacted, may have on our business in the future. These changes could, among other things, require modifications to our manufacturing methods or facilities, expanded or different labeling, new approvals, the recall, replacement or discontinuance of certain products, additional record keeping and expanded documentation of the properties of certain products and scientific substantiation. These changes, or new legislation, could have a material adverse effect on our business, financial condition, results of operations and cash flows.

An increase in product liability claims or product recalls could harm our business.

We face an inherent business risk of exposure to product liability claims in the event that the use of our technologies or products is alleged to have resulted in adverse effects. These risks exist for products in clinical development and with respect to products that have received regulatory approval for commercial sale. While we have taken, and will continue to take, what we believe are appropriate precautions, we may not be able to avoid significant product liability exposure. We currently have product liability insurance, however, we cannot assure you that the level or breadth of any insurance coverage will be sufficient to cover fully all potential claims. Also, adequate insurance coverage might not be available in the future at acceptable costs, if at all. For example, we are now not able to obtain product liability insurance with respect to our products Menest®, Delestrogen® and Pitocin®, each a women s healthcare product. With respect to any product liability claims relating to these products, we could be responsible for any monetary damages awarded by any court or any voluntary monetary settlements. Significant judgments against us for product liability for which we have no insurance could have a material adverse effect on our business, financial condition, results of operations and cash flows.

Product recalls or product field alerts may be issued at our discretion or at the discretion of the FDA, other government agencies or other companies having regulatory authority for pharmaceutical product sales. From time to time, we may recall products for various reasons, including failure of our products to maintain their stability through their expiration dates. Any recall or product field alert has the potential of damaging the reputation of the product or our reputation. To date, these recalls have not been significant and have not had a material adverse effect on our business, financial condition, results of operations or cash flows. However, we cannot assure you that the number and significance of recalls will not increase in the future. Any significant recalls could materially affect our sales and the prescription trends for the products and damage the reputation of the products or our reputation. In these cases, our business, financial condition, results of operations and cash flows could be materially adversely affected.

Any reduction in reimbursement levels by managed care organizations or other third-party payors may have an adverse effect on our revenues.

Commercial success in producing, marketing and selling branded prescription pharmaceutical products depends, in part, on the availability of adequate reimbursement from third-party health care payors, such as the government, private health insurers and managed care organizations. Third-party payors are increasingly

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challenging whether to reimburse certain pharmaceutical products and medical services. For example, many managed health care organizations limit reimbursement of pharmaceutical products. These limits may take the form of formularies with differential co-pay tiers. The resulting competition among pharmaceutical companies to maximize their product reimbursement has generally reduced growth in average selling prices across the industry. We cannot assure you that our products will be appropriately reimbursed or included on the formulary lists of managed care organizations or any or all Medicare Part D plans, or that downward pricing pressures in the industry generally will not negatively impact our operations.

The commercial success of some of our products depends, in part, on whether third-party reimbursement is available for the use of our products by hospitals, clinics, doctors, pharmacies and patients. Third-party payors include state and federal governments, under programs such as Medicaid, Medicare and other entitlement programs, as well as managed care organizations, private insurance plans and health maintenance organizations. Because of the growing size of the patient population covered by third-party reimbursement, it is important to our business that we market our products to reimbursers that serve many of these organizations. Payment or reimbursement of only a portion of the cost of our prescription products could make our products less attractive, from a net-cost perspective, to patients, suppliers, retail pharmacies and prescribing physicians. Managed care organizations and other third-party payors try to negotiate the pricing of products to control their costs. Managed care organizations and pharmacy benefit managers typically develop reimbursement coverage strategies, including formularies, to reduce their cost for medications. Formularies can be based on the prices and/or therapeutic benefits of the available products. Due to their lower costs, generics receive more favorable reimbursement. The breadth of the products reimbursed varies considerably from one managed care organization to another, and many formularies include alternative and competitive products or therapies for treatment of particular medical conditions. Denial of a product from reimbursement can lead to its sharply reduced usage in the managed care organization patient population. If our products are not included within an adequate number of formularies or adequate reimbursement levels are not provided, or if those policies increasingly favor generic products, our market share and gross margins could be negatively affected, as could our overall business and financial condition.

We have addressed our contract relationship with managed care organizations in an effort to increase the attractiveness of reimbursements for our products. We take reserves for the estimated amounts of rebates we will pay to managed care and government organizations each quarter. Any increased usage of our products through Medicaid, Medicare, or managed care programs will increase the amount of rebates that we owe. We cannot assure you that our products will be included on the formulary lists of managed care or Medicare organizations or that adverse reimbursement issues will not have a material effect on our business, financial condition, results of operations or cash flows.

If we fail to comply with the safe harbors provided under various federal and state laws, our business could be adversely affected.

We are subject to various federal and state laws pertaining to health care fraud and abuse, including anti-kickback laws and false claims laws. Anti-kickback laws make it illegal for a prescription drug manufacturer to solicit, offer, receive, or pay any remuneration in exchange for, or to include, the referral of business, including the purchase or prescription of a particular drug. The federal government has published regulations that identify safe harbors or exemptions for certain payment arrangements that do not violate the anti-kickback statutes. We seek to comply with these safe harbors. Due to the breadth of the statutory provisions and the absence of guidance in the form of regulations or court decisions addressing some of our practices, it is possible that our practices might be challenged under anti-kickback or similar laws. False claims laws prohibit anyone from knowingly (in the civil context), or knowingly and willfully (in the criminal context), presenting, or causing to be presented for payment to third-party payors (including Medicaid and Medicare) claims for reimbursed drugs or services that are false or fraudulent, claims for items or services not provided as claimed, or claims for medically unnecessary items or services.

Violations of fraud and abuse laws may be punishable by civil and/or criminal sanctions, including fines and civil monetary penalties, as well as the possibility of exclusion from federal health care programs,

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including Medicaid and Medicare. Any such violations could have a material adverse effect on our business, financial condition, results of operations and cash flows.

In the future, the publication of negative results of studies or clinical trials may adversely impact our products.

From time to time studies or clinical trials on various aspects of pharmaceutical products are conducted by academics or others, including government agencies, the results of which, when published, may have dramatic effects on the markets for the pharmaceutical products that are the subject of the study. The publication of negative results of studies or clinical trials related to our products or the therapeutic areas in which our products compete could adversely affect our sales, the prescription trends for our products and the reputation of our products. In the event of the publication of negative results of studies or clinical trials related to our branded pharmaceutical products or the therapeutic areas in which our products compete, our business, financial condition, results of operations and cash flows could be materially adversely affected. Additionally, potential write-offs of the intangible assets associated with the affected products could materially adversely affect our results of operations.

New legislation or regulatory proposals may adversely affect our revenues.

A number of legislative and regulatory proposals aimed at changing the health care system, including the cost of prescription products, importation and reimportation of prescription products from countries outside the United States and changes in the levels at which pharmaceutical companies are reimbursed for sales of their products, have been proposed. While we cannot predict when or whether any of these proposals will be adopted or the effect these proposals may have on our business, these proposals, as well as the adoption of any other proposals, may exacerbate industry-wide pricing pressures and could have a material adverse effect on our business, financial condition, results of operations and cash flows. For example, in 2000, Congress directed the FDA to adopt regulations allowing the reimportation of approved drugs originally manufactured in the United States back into the United States from other countries where the drugs were sold at a lower price. Although the Secretary of Health and Human Services has refused to implement this directive, in July 2003 the House of Representatives passed a similar bill that does not require the Secretary of Health and Human Services to act. The reimportation bills have not yet resulted in any new laws or regulations; however, these and other initiatives could decrease the price we receive for our products. Additionally, sales of our products in the United States could be adversely affected by the importation of products that some may deem to be equivalent to ours that are manufactured by others and are available outside the United States. Many states have implemented or are in the process of implementing regulations requiring pharmaceutical companies to provide them with certain marketing and pricing information. While we intend to comply with these regulations, we are unable at this time to predict or estimate the effect of these regulations, if any.

Changes in the Medicare, Medicaid or other governmental programs or the amounts paid by those programs for our services may adversely affect our earnings. These programs are highly regulated and subject to frequent and substantial changes and cost containment measures. In recent years, changes in these programs have limited and reduced reimbursement to providers. The Medicare Prescription Drug, Improvement and Modernization Act of 2003, creates a voluntary prescription drug benefit under the Social Security Act, which we refer to as Medicare Drug Benefit. Beginning in 2006, Medicare beneficiaries entitled to Part A or enrolled in Part B, as well as certain other Medicare enrollees, are eligible for the Medicare Drug Benefit. Regulations implementing the Medicare Drug Benefit were published January 28, 2005. The Medicare Drug Act requires that the Federal Trade Commission conduct a study and make recommendations regarding additional legislation that may be needed concerning the Medicare Drug Benefit. We are unable at this time to predict or estimate the financial effect of this new legislation.

The Deficit Reduction Act of 2005 added provisions to the Medicaid Rebate Program that will modify the formulas used in the rebate calculations, the frequency with which they must be performed, the manner in which sales of authorized generic products are considered in the calculations, and other matters. These changes may have the effect

of increasing our Medicaid Rebate expense, but we cannot yet estimate the precise financial effect.

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The pharmaceutical industry is highly competitive, and other companies in our industry have much greater resources than we do.

In our industry, comparatively smaller pharmaceutical companies like us compete with large, global pharmaceutical companies with substantially greater financial resources for the acquisition of products in development, currently marketed products, technologies and companies. We cannot assure you that

- we will be able to continue to acquire commercially attractive pharmaceutical products, companies or technologies;
- additional competitors will not enter the market; or
- competition for acquisition of products in development, currently marketed products, companies and technologies will not have a material adverse effect on our business, financial condition and results of operations.

We also compete with pharmaceutical companies in marketing and selling pharmaceutical products. The selling prices of pharmaceutical products typically decline as competition increases. Further, other products now in use, developed or acquired by other pharmaceutical companies may be more effective or offered at lower prices than our current or future products. Competitors may also be able to complete the regulatory process sooner and, therefore, may begin to market their products in advance of ours. We believe that competition for sales of our products will continue to be based primarily on product efficacy, safety, reliability, availability and price.

Competition for Acquisitions and In-License Opportunities. We compete with other pharmaceutical companies for product and product line acquisitions and in-license opportunities. These competitors include Biovail Corporation, Forest Laboratories, Inc., Medicis Pharmaceutical Corporation, Shire Pharmaceuticals Group plc, Watson Pharmaceuticals, Inc., Wyeth, Pfizer, Inc., Bristol Myers Squibb, Sanofi Aventis, GlaxoSmithKline and other companies which either in-license pharmaceutical product opportunities or compounds, or acquire branded pharmaceutical products and product lines, including those in development, from other biotech, pharmaceutical or bio-pharma companies. We cannot assure you that

- we will be successful in the acquisition, or in-license of commercially attractive pharmaceutical opportunities, compounds, products, companies or technologies,
- additional competitors will not enter the market,
- competition for acquisition and in-license of pharmaceutical opportunities, compounds or products, including products in development, currently marketed products, companies and technologies will not have a material adverse effect on our business, financial condition and results of operations, or
- we will be successful in bringing compounds, products in development or other opportunities to commercial success.

Product Competition. Additionally, since our currently marketed products are generally established and commonly sold, they are subject to competition from products with similar qualities.

Our largest selling product Altace® competes in a very competitive and highly genericized market with other cardiovascular therapies.

Our product Skelaxin® competes in a highly genericized market with other muscle relaxants.

Our product Sonata® competes with other insomnia treatments in a highly competitive market.

Our product Levoxyl® competes in a competitive and highly genericized market with other levothyroxine sodium products.

We anticipate competition from bovine, recombinant human and human thrombin for our product Thrombin-JMI® in the near future. Omrix Biopharmaceuticals, Inc. filed a Biologics Licensing Application (BLA) in early November 2006 for its human thrombin product. We anticipate that Zymogenetics, Inc. will file a BLA for its recombinant human thrombin product in the fourth quarter of 2006.

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Many of our branded pharmaceutical products have either a strong market niche or competitive position. Some of our branded pharmaceutical products face competition from generic substitutes.

The manufacturers of generic products typically do not bear the related research and development costs and, consequently, are able to offer such products at considerably lower prices than the branded equivalents. We cannot assure you that any of our products will remain exclusive without generic competition, or maintain their market share, gross margins and cash flows as a result of these efforts, the failure of which could have a material adverse effect on our business, financial condition, results of operations and cash flows.

A WARNING ABOUT FORWARD-LOOKING STATEMENTS

This report includes forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements relate to analyses and other information which are based on forecasts of future results and estimates of amounts that are not yet determinable. These statements also relate to our future prospects, developments and business strategies.

These forward-looking statements are identified by their use of terms and phrases, such as anticipate, believe, could, estimate, expect, intend, may, plan, predict, project, will and other similar terms and phrases, including assumptions. These statements are contained in the Risk Factors, and Management s Discussion and Analysis of Financial Condition and Results of Operations sections, as well as other sections of this report.

Forward-looking statements in this report include, but are not limited to:

- the future potential of, including anticipated net sales and prescription trends for, our branded pharmaceutical products, particularly Altace®, Skelaxin®, Thrombin-JMI®, Sonata® and Levoxyl®;
- expectations regarding the enforceability and effectiveness of product-related patents, including in particular patents related to Altace®, Skelaxin®, Sonata® and Adenoscan®;
- expected trends and projections with respect to particular products, reportable segments and income and expense line items;
- the timeliness and accuracy of wholesale inventory data provided by our customers;
- the adequacy of our liquidity and capital resources;
- anticipated capital expenditures;
- the development, approval and successful commercialization of Remoxy™, an investigational drug for the treatment of moderate-to-severe chronic pain; binodenoson, our next generation cardiac pharmacologic stress-imaging agent; bremelanotide, an investigational new drug for the treatment of erectile dysfunction and female sexual dysfunction; T-62, an investigational drug for the treatment of neuropathic pain; MRE0094, an investigational drug for the topical treatment of chronic diabetic foot ulcers; the development of a new formulation of Skelaxin®; pre-clinical programs; and product life-cycle development projects;
- the development, approval and successful commercialization of a diazepam-filled auto-injector, new inhaler for Intal® and Tilade® using the alternative propellant HFA, and an Altace®/diuretic combination product;
- our successful execution of our growth strategies;

anticipated developments and expansions of our business;

our plans for the manufacture of some of our products, including but not limited to, the anticipated expansion of our manufacturing capacity for Thrombin-JMI®;

anticipated increases in sales of acquired products or royalty revenues;

the success of our Amended Co-Promotion Agreement with Wyeth;

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the high cost and uncertainty of research, clinical trials and other development activities involving pharmaceutical products;

the development of product line extensions;

the unpredictability of the duration or future findings and determinations of the FDA, including the pending applications related to our diazepam-filled auto-injector and a new Intal® inhaler formulation utilizing HFA, and other regulatory agencies worldwide;

products developed, acquired or in-licensed that may be commercialized;

the intent, belief or current expectations, primarily with respect to our future operating performance;

expectations regarding sales growth, gross margins, manufacturing productivity, capital expenditures and effective tax rates;

expectations regarding the outcome of various pending legal proceedings including the Altace® and Skelaxin® patent challenges, the SEC and Office of Inspector General investigations, other possible governmental investigations, securities litigation, and other legal proceedings described in this report; and

expectations regarding our financial condition and liquidity as well as future cash flows and earnings.

These forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause actual results to be materially different from those contemplated by our forward-looking statements. These known and unknown risks, uncertainties and other factors are described in detail in the Risk Factors section and in other sections of this report.

Item 3. ***Quantitative and Qualitative Disclosures about Market Risk***

Certain of our financial instruments are subject to market risks, including interest rate risk. Our financial instruments are not currently subject to foreign currency risk or commodity price risk. We have no financial instruments held for trading purposes.

As of September 30, 2006, there were no significant changes in our qualitative or quantitative market risk since the end of our fiscal year ended December 31, 2005.

We have marketable securities which are carried at fair value based on current market quotes. Gains and losses on securities are based on the specific identification method.

The fair market value of long-term fixed interest rate debt is subject to interest rate risk. Generally, the fair market value of fixed interest rate debt will decrease as interest rates rise and increase as interest rates fall. In addition, the fair value of our convertible debentures is affected by our stock price.

Item 4. ***Controls and Procedures***

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under

the Securities Exchange Act of 1934 (the Exchange Act)). Based on this evaluation, our Chief Executive Officer and Chief Financial Officer have reasonable assurance that our disclosure controls and procedures are effective to ensure that information required to be disclosed in our reports filed under the Exchange Act is recorded, processed, summarized and reported within the time periods specified, and that management will be timely alerted to material information required to be included in our periodic reports filed with the Securities and Exchange Commission.

During our most recent fiscal quarter, there has not occurred any change in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II OTHER INFORMATION

Item 1. ***Legal Proceedings***

The information required by this Item is incorporated by reference to Note 9 to the condensed consolidated financial statements included elsewhere in this report.

Item 1A. ***Risk Factors***

The information required by this item is incorporated by reference to Item 2 of Part I of this report, Management s Discussion and Analysis of Financial Condition and Results of Operations.

Item 6. ***Exhibits***

Exhibit Number	Description
10.1	Amended and Restated Co-Promotion Agreement, dated July 5, 2006, between King Pharmaceuticals, Inc. and Wyeth
10.2	Settlement Agreement, dated July 31, 2006, between King Pharmaceuticals, Inc., the Affected Current and Former Officers and Directors and the Plaintiffs in the Consolidated Class Action
10.3(1)*	Amendment to the Director Compensation Policy for the Non-Employee Directors of King Pharmaceuticals, Inc., dated August 2, 2006
10.4*	Form of Restricted Unit Certificate and Restricted Unit Grant Agreement
10.5(2)	Purchase Agreement for the Acquisition of the Rights in and to Avinza, dated September 6, 2006, between King Pharmaceuticals, Inc. and Ligand Pharmaceuticals, Inc.
31.1	Certification by Chief Executive Officer Pursuant to Rule 13a-14(a) or 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification by Chief Financial Officer Pursuant to Rule 13a-14(a) or 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification by Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification by Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Denotes Management Contract or Compensatory Plan or Arrangement

1 Incorporated by Reference to King s Current Report on Form 8-K filed on August 8, 2006

2 Incorporated by Reference to King s Current Report on Form 8-K filed on September 12, 2006

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

KING PHARMACEUTICALS, INC.

By: /s/ BRIAN A. MARKISON
Brian A. Markison
President and Chief Executive Officer

Date: November 9, 2006

By: /s/ JOSEPH SQUICCIARINO
Joseph Squicciarino
Chief Financial Officer

Date: November 9, 2006