

November 25, 2015

Investors have a right to be skeptical of Valeant's review process

When a public company has problems, quite often its board creates a committee of independent directors to look into whatever allegations it might be facing. It is a frequent response to trouble.

Which brings us to Valeant Pharmaceuticals International Inc., which, you may have heard, has problems, perhaps too many to enumerate. Chief among them, however, is Philidor Rx, the “specialty pharmacy” that counted Valeant as its only customer, dispensing the company’s products to end users at robust prices. Valeant had an [option](#) to buy Philidor, which we didn’t know until months after the fact, and Philidor apparently had Valeant employees working for it under assumed names, which Valeant may or may not have known about.

So, once these and many other allegations and questions arose about Philidor, Valeant appointed an “ad hoc committee” of its board “to review allegations related to the company’s business relationship with Philidor and related matters.” Four days later, Valeant cut ties with Philidor.

Is the company on the right track in actively dealing with the concerns? Perhaps. But investors who have found so much to question at Valeant might also be skeptical about how this review will turn out.

For more, I turn to **Veritas Investment Research**, the firm that has been a leader in Valeant skepticism since 2011 and the source for my doubting columns on the company. (As I have frequently noted, Valeant’s awesome multiyear share performance until this year made **Veritas**, and me, look silly at the time. Maybe not as much now.)

Here are some of **Veritas** analyst **Dimitry Khmelnitsky’s** concerns about the committee:

- Three-quarters of the committee have a conflict of interest because, in essence, they are reviewing their own work. Committee chair Bob Ingram, who is Valeant’s lead independent director, Norma Provencio, who also serves as the head of Valeant’s audit and risk committee, and Colleen Goggins, a member of the company’s finance and transactions committee, all approved the purchase of the option to buy Philidor in their capacity as board members. Ms. Provencio and Ms. Goggins sat on committees that reviewed the Philidor transaction before referring it to the full board. And Ms. Provencio, in her audit committee role, toured the Philidor facility before Valeant did the deal.
- Mason Morfit, the fourth member of the committee, has a conflict of ownership because he’s the president of ValueAct Capital, which owns 5.6 per [cent](#) of the company. Mr. Morfit, **Mr. Khmelnitsky** says, “has a vested interest in keeping the [stock](#) price up.”
- Mr. Ingram, the ad hoc committee chair, issued a statement in the very same press release announcing the creation of the committee that said: “The board has complete confidence in Mike Pearson’s performance as CEO and has fully supported the company’s specialty pharmacy strategy.” This, **Mr. Khmelnitsky** says, is a prejudicial statement.

All this speaks to the questionable independence of the committee’s review. It’s also important to note what the committee isn’t doing. In that Oct. 26 announcement, Valeant said its “audit and risk committee and the full board of directors have reviewed the company’s accounting for its Philidor arrangement and have confirmed the appropriateness of the company’s related [revenue](#) recognition and accounting treatment.” That, then, is not a matter of review for the independent committee.

An alternative path for Valeant might have been to hire an outside law firm to conduct an investigation and prepare a report delivered directly to the board. That, however, is not the path Valeant took.

Mr. Khmelnitsky is particularly concerned because he was able to review a Philidor employee manual that outlined “a couple of different ‘back door’ approaches to receive payment from the insurance company,” specifically submitting multiple pharmacy ID numbers until one is accepted. Says **Mr. Khmelnitsky**: “Assuming top management knew nothing about Philidor practices, it seems that Valeant’s system of internal controls is deficient because it failed to detect and remedy potentially fraudulent transactions at its subsidiary. ... Furthermore, management’s obliviousness in respect of Philidor-related irregularities indicates that [Valeant’s] due diligence and board oversight are deeply flawed.”

I brought the concerns to Valeant, and here’s the response, courtesy of a company spokesman: The ad hoc committee is being advised by a former deputy U.S. attorney-general, Mark Filip of Kirkland & Ellis LLP, “on the scope and conduct of its investigation.”

The spokesman also added that the committee members are not compromised by their past approvals of the Philidor transaction because they are “independent directors who fully understand their fiduciary duties and who are being advised by independent outside legal counsel”; Mr. Morfit “is a seasoned and respected corporate director whose interests are fully aligned with those of all Valeant shareholders by virtue of his firm’s large stake in the company”; and Mr. Ingram’s statement of support of Mr. Pearson does not suggest he cannot conduct an independent and unbiased investigation. He also referenced that in conference calls, the company has defended its internal controls and board oversight.

So all is well with the review process, in Valeant’s eyes. In due time, we will find out if Valeant’s ad hoc committee finds anything particularly damning. Call it a prejudicial statement, but I don’t have complete confidence it will.