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THE VALEANT MELTDOWN AND WALL STREET'S MAJOR DRUG PROBLEM

By 2015, C.E.O. Michael Pearson had built Valeant Pharmaceuticals into a nearly $90 billion colossus. Today, the company is under investigation for price gouging, and major Wall Street players are feeling the side effects. Pearson's fall (which came with a $9 million severance package last week), exposes more than the dark side of the the health-care system—it indicts some of finance's biggest players.

BY BETHANY MCLEAN

Hedge-fund managers Bill Ackman and Jim Chanos, former Allergan C.E.O. David Pyott, and former Valeant C.E.O. Michael Pearson.

Photographs by C. Bibby/Financial Times-REA/Redux (Pyott), Christinne Muschi/Reuters (Background), David Orrell/NBCU Photo Bank/Getty Images (Chanos), © Kristoffer Tripplaar/Alamy Stock Photo (Ackman), by Kristoffer Tripplaar/Sipa USA (Pearson).

N wasn't expecting drama on a routine visit to the eye doctor. But fortunately her doctor had a lifesaving insight for both her and her sister, K: "I think you have Wilson's disease," he told N after noticing strange golden-brown rings in her irises.

Wilson's is a rare inherited disorder—only one in about 30,000 people worldwide has it—in which the body can't metabolize copper. Untreated, it can lead to fluid buildup, jaundice, neurological issues, and fatal liver failure. There was no surefire treatment until the mid-1950s, when a British doctor discovered two drugs that now go under the trade names Cuprimine and Syprine. Today these are the standard treatments for Wilson's, and they must be taken for life.

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The sisters began taking Syprine in 1987. Their symptoms went away, and they both went on to highly successful careers, N as a public-relations executive and K in the wealth-management division of a major investment firm. Their insurance covered the cost of the drug, which wasn't much because Syprine is simple to make. The sisters were vaguely aware that, in the latter part of the aughts, their co-pays, originally next to nothing, had started to climb, but health insurance still insulated them from the realities of drug pricing.

That is, until it didn't, in 2014, when N went to her local Walgreens to pick up her lifesaving supply of Syprine—and found that her insurance company had denied coverage on the grounds that the drug was too expensive. Shocked, she asked the pharmacist the cost. She remembers him saying it had risen to around $20,000 for a month's supply. She eventually managed to get coverage—after all, treating her for liver failure would have been more expensive—but the co-pays have continued to climb. She and K now pay $500 and $400, respectively, for a three-month supply.

Syprine, which can be had for $1 a pill in some countries, now has a list price of around $300,000 for a year's supply in the United States; Cuprimine has seen a similar price increase. There is no generic version of either, in part because of a huge backlog for new drug approvals at the F.D.A.

Both sisters have done well financially, but their health insurance in retirement is uncertain, and they are terrified about the consequences if their co-pays eventually get calculated as a percentage of a drug's total cost, the likelihood of which is "1,000 percent," according to Art Caplan, the head of the medical-ethics division at New York University. "I have advantages, but I can't fix this," says K. "You are at the mercy of this abhorrent system."

N's husband, J, began investigating the impenetrable "hot mess"—as Caplan calls it—of how drugs get priced in the U.S. He found that, in 2006, Merck, which had originally owned Cuprimine and Syprine, sold the drugs to a small company called Aton, which began raising the prices. Then, in 2010, Aton sold the drugs to Valeant Pharmaceuticals.

In 2014, J read an article in *The Wall Street Journal* about Valeant and its C.E.O., 55-year-old Michael Pearson, and the reasons for the outrageous price increases of his wife's medicine became clearer. "Supporters say Mr. Pearson's approach should be a blueprint for the pharmaceutical industry's future: Grow through serial deal-making, including tax 'inversion' purchases of foreign companies to take advantage of lower tax rates [abroad]. Cut costs aggressively. And, above all, stop spending so much money on risky research," wrote the *Journal*. The article quoted Mason Morfit, the president of ValueAct Capital, a prominent investment fund, saying that Pearson "is the best CEO I've ever worked with."

J learned that Valeant had bought Aton, for $318 million in 2010. In presentations Pearson bragged to investors that the purchase had quickly earned back 2.5 times its cost. Though the patient base for Syprine is tiny, the drug, thanks to its exorbitant price hikes, had become one of Valeant's top-20 drugs by revenue by 2014. "I realized these guys were going to raise prices however much they wanted with no consequences," J says.

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By 2015, Pearson had built his company into a colossus with an equity market value of around $90 billion. But Valeant's questionable tactics finally caught up with him this year. In six months 90 percent of the company's value disappeared. Now Valeant is well on its way to becoming the corporate scandal of its era. The Justice Department, the Securities and Exchange Commission, three state agencies, and two congressional committees are investigating. Pearson, a supremely confident, complicated, controversial man who exerted an oddly powerful hold over his many admirers, has been forced out of the company.

One of Valeant's biggest investors, hedge-fund billionaire Bill Ackman, is trying to salvage both the multi-billion-dollar investment his fund, Pershing Square, made in the company and—with Pershing Square down 18 percent so far this year after a 19 percent loss last year in part due to Valeant—his own reputation. Ackman is far from alone. The investors in Valeant were once viewed as a Who's Who of the smartest guys on Wall Street. The company's fall is wrecking both their careers and their legacies. "It is as much an indictment of Wall Street as it is of Mike Pearson," says a pharmaceutical-industry C.E.O. An irascible Californian named Andrew Left, who runs Citron, a research firm, published a report that asked whether Valeant was "the pharmaceutical Enron."

Valeant was the pure expression of the view that companies are there to make money for shareholders, every other consideration be damned. It raises fundamental questions about the functioning of our health-care system, the nature of modern markets, and the slippery slope of ethical rationalizations. "It's the dark side of capitalism," says one prominent investor.

IMPROBABLE BEGINNINGS

Originally named ICN, Valeant was founded in an Orange County garage by Milan Panic, an Olympic cyclist who defected from Yugoslavia in the 1950s, only to return to his homeland as prime minister in the early 1990s at the invitation of President Dobrica Cosic. As students of history know, that did not end well, as the region imploded in war and ethnic hatred.

The company Panic left behind, renamed Valeant in 2003, didn't fare much better. His reign at ICN was marred by underperformance and lawsuits, but in the mid-2000s, the company attracted the attention of a then small investment fund called ValueAct, founded by Jeff Ubben, a former Fidelity money manager who aspired to be an activist investor. By the end of 2006, ValueAct owned 13.2 million shares of Valeant, for which it had paid about $225 million.

"I REALIZED THESE GUYS WERE GOING TO RAISE PRICES HOWEVER MUCH THEY WANTED WITH NO CONSEQUENCES."

To help fix the flailing business, Valeant's then chairman, Robert Ingram, brought in Mike Pearson, a McKinsey consultant who had worked with him at the pharmaceutical giant Glaxo Wellcome, and in early 2008, Pearson became Valeant's C.E.O. He had grown up in southern Ontario and graduated summa cum laude from Duke University, with a degree in engineering, before getting an M.B.A. from the University of Virginia. During his 23 years at McKinsey, Pearson consulted for several large pharmaceutical companies. "Mike made money hand over fist because he could sell business to a stone," says a person who worked with him at McKinsey.

In Pearson's view, pharmaceutical companies had bloated costs due to years of huge profits, and despite the billions they spent on research and development, they were producing few new F.D.A.-approved drugs. Why not cut costs and instead acquire companies that had surefire products? This would produce higher returns than traditional R&D, he told investors. "Don't bet on science—bet on management" was one of his mottos. "Low-cost, low-risk programs—singles and doubles, not home runs" was another.

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Pearson saw the world solely in terms of dollars and cents. One investor remembers him at a health-care conference where most attendees were wearing pink ribbons in support of breast-cancer research and treatment. Someone asked Pearson what he thought of cancer research. According to this person, he said, "I think it's a losing proposition. I don't know any pharmaceutical company who has generated positive returns on it."

ValueAct had its own theories about improving management, one of which was that executives should be rewarded for performance—as measured by stock price. So Pearson, who had to invest $5 million worth of his own Valeant stock, was paid little in cash, but stood to do well if Valeant's stock did well—and make a fortune if Valeant's stock went up significantly. Nor was he allowed to sell stock until long after he had left the company. One early investor recalls meeting Pearson in a conference room at a midtown-Manhattan hotel in 2008. Pearson claimed that just by cutting costs he could get Valeant's stock to $40. Within three years, he did just that, giving anyone who owned the stock in 2008 more than a five-fold return.

The stock's rise was also due to Pearson's debt-fueled acquisition spree. Thanks to record-low interest rates in the wake of the 2008 financial crisis, it was easy to borrow money. Valeant bought well over 100 companies, including contact-lens-maker Bausch & Lomb. In 2010 he merged Valeant with a Canadian company called Biovail, which was using offshore subsidiaries in Barbados and Luxembourg in order to pay as little tax as possible. Such "inversion" deals, in which American companies move their headquarters to lower-tax locales, soon became very popular. But Pearson was a pioneer. With the Biovail deal Valeant acquired the lowest tax rate of any pharmaceutical company in the world, less than 5 percent. That wasn't Pearson's only tax trick. The prominent investor says the company also engaged in earnings stripping, a common practice in which a company charges interest on debt to its American subsidiaries to wipe out profits that might be taxed at the higher U.S. rate.

In person Pearson was nothing like the typical polished, well-dressed pharmaceutical C.E.O. "He was his own person," says someone who worked with him at McKinsey. "Fat, pants riding low, fleece jackets." Nor

was he a glad-hander. Pearson described himself as “pragmatic” and “very fact-based.” To many investors he was a truth-teller. Although he was gruff, he had a sense of humor that some found disarming. No one questioned how hard he worked or how intelligent he was. Investors liked the theory behind Valeant, and they liked that Pearson was an iconoclast. “He did not care at all about preconceived notions of how things are supposed to be done,” says a former Valeant investor.

Investors thought he spoke their language. He’d say, “All I care about is our shareholders,” and he talked in terms of cash returns and accountability. Many investors don’t like traditional pharmaceutical companies due to the inherent unpredictability of drug development. By slashing those costs, Pearson created not only more short-term profits but also a company where everything seemingly could be quantified on a spreadsheet. Big investors dealt directly with him, and in private meetings he kept them apprised of the details of the business, making them feel like he had their backs. The business model was pitched as “ ‘The rest of the industry is stupid and we are smarter than everyone.’ That’s very appealing to people who think they’re smart,” says Anthony Scilipoti, a founding partner at Canada’s ***Veritas Investment Research***, the only firm in 2014 to put a “sell” rating on Valeant.

It was indisputable that Pearson produced the results he promised. “You can’t bet against Mike” became a Wall Street refrain. “Anytime you ask someone their investment thesis and in the first sentence they call the C.E.O. by the first name, that’s not an investment,” observes one investor, who was skeptical of Valeant. “That’s a cult.” He adds, “They have all ended badly.” When this person considered investing in Valeant, he checked Pearson’s background and was repeatedly told, “He has demons.”

Pearson was close to several pharmaceutical C.E.O.’s, including former Johnson & Johnson chairman Bill Weldon (whose son, Ryan Weldon, became a senior executive at Valeant in his early 30s). At McKinsey one of Pearson’s jobs had been to advise Johnson & Johnson on squeezing costs after its $16.6 billion 2006 purchase of Pfizer’s consumer health-care business. The goal was to make the combined business meet the profit targets the company had promised Wall Street. Three former Johnson & Johnson executives blame the cost cuts for what *Fortune*, in a 2010 investigative report, called a “systemic breakdown in quality control” at a major division within the company, which led to the recall of multiple products and a congressional investigation.

“[Pearson] was shoved down our throats,” says a former Johnson & Johnson executive. “What I have heard over and over again is that he kind of just makes it up as he goes along,” says another former Johnson & Johnson executive. “In that situation, he made it up. He’d put people in a room and say, ‘Figure it out until we have the numbers we need to show people.’”

Inside Valeant, people took some pride in a culture that was “We’re the bad boys, we’re successful, we can do whatever we want,” as one former Valeant executive puts it. It was a tough place. Pearson had no qualms about firing employees who disappointed him. “In business you are supposed to make money,” he explained to investors, in a meeting which was taped. “We expect everyone to make money. If a business does not make money, we either exit that business or we fire the person running that business. Usually we fire the person running that business.” Senior executives came and went with astounding rapidity, because it was Mike’s way or the highway. (The board did not do exit interviews.)

“Valeant’s entire existence raised a middle finger to the rest of the industry,” says one investor, explaining why the industry detested Pearson. The problem, though, wasn’t so much Pearson’s ideas, but rather his execution of them. While in the process of acquiring Medicis, a company that made aesthetic products in the same vein as Botox, Pearson reassured the company’s employees that, while there would be a “best of the best” competition for jobs, he expected the Medicis people to win, and there would be even more jobs at the company’s Scottsdale, Arizona, headquarters in a year. Instead, the day the deal closed, almost all the employees were presented with black folders that notified them they were fired. “I was sickened by the deception,” says Jonah Shacknai, Medicis’s former C.E.O. Another C.E.O. says Pearson told him he would never make a hostile offer to acquire his company, only to have Pearson turn around and do exactly that.

His very success seemed to make Pearson less satisfied and even more aggressive, maybe because delivering results that would keep the stock price rising became harder as Valeant got bigger. “There is an underlying factual basis” to some of Pearson’s theories, says another pharmaceutical executive. “But the thesis became a slogan.”

Pearson's dark side was also an issue in his personal life. In September 2009, he was charged with driving while intoxicated by a New Jersey police officer, who noted in his report that the car reeked of alcohol. When the officer first asked Pearson how much he had had to drink, Pearson replied, "Nothing." But he was unable to recall the address of his workplace and couldn't perform the sobriety tests. Pearson pleaded guilty to driving under the influence and lost his license for three months.

Stories about Pearson's indiscreet drinking circulated widely both in the pharmaceutical industry and on Wall Street, although alcohol never seemed to interfere with his work. In 2012, however, one early investor, Cara Goldenberg, became so concerned that she sold her stake, and went to a board member along with two other investors, advising them of "key-man risk"—Wall-Street-speak for having money locked in when an important team member leaves.

Investors shrugged it off—where is the line between a rumored personal issue and a professional problem?—and anyway, the whole scheme was working so well. Valeant's revenues exploded from $1 billion in 2010 to more than $8 billion in 2014. On Wall Street, Valeant became a stock you had to own. After all, the smartest of the smart, including a pack of the so-called Tiger Cubs—hedge funds run by men who had worked for famed investor Julian Robertson's Tiger Management—acquired big stakes in Valeant. So didJohn Paulson, whose eponymous fund made billions in the subprime crisis, and Glenn Greenberg, a well-known investor who runs the Brave Warrior fund.

Even Sequoia, a storied and highly successful mutual fund (no relation to the venture-capital firm Sequoia Capital), began buying Valeant in 2010. Bob Goldfarb, Sequoia's fund manager, told its investors in 2014, "It would be a huge mistake to underestimate Mike Pearson. Do not bet against him. He has a different vision of the pharmaceutical industry from that of anyone of whom I am aware. And he has executed that vision very successfully to date."

And don't forget ValueAct, which grew into a highly regarded fund, in no small measure due to the huge success of its investment in Valeant. "We are all in on you guys and are very excited about it," one ValueAct partner e-mailed Pearson in 2014. Other investors took comfort in ValueAct's presence on the board, because, after all, that had to mean Valeant was being well managed and Pearson was being watched. But although ValueAct still owned a huge stake in Valeant, the fund was essentially playing with house money: by the end of 2010, it had gotten more in cash from dividends and stock sales than its original investment had cost. (ValueAct was required to sell stock when Valeant became more than 20 percent of its overall portfolio.)

WATERLOO

In April 2014 Mike Pearson stood in front of a crowd of investors and analysts at New York's Equitable Center with Bill Ackman. Ackman's Pershing Square hedge fund wasn't investing in Valeant; it was helping to fund Pearson's biggest takeover yet: a $50 billion hostile offer for Allergan, the superstar maker of Botox. "I want to reassure you that Valeant still worries about every penny, and this whole production is all being paid for by Bill Ackman," Pearson told the crowd. Everyone laughed.

"VALEANT'S ENTIRE EXISTENCE RAISED A MIDDLE FINGER TO THE REST OF THE INDUSTRY," SAYS ONE INVESTOR.

After lunch, Ackman handed out copies of *The Outsiders*, a book by William Thorndike, which celebrated "outsider" C.E.O.'s, mavericks who had done things differently, such as Buffett, TCI's John Malone, and Washington Post Co. C.E.O. Katharine Graham. Ackman told investors Pearson's name should be added to the list.

The takeover deal had begun when Ackman's Harvard Business School classmate, Bill Doyle, who knew Pearson from a brief stint at McKinsey in the early 90s, suggested the two meet. Ackman had never invested in a pharmaceutical company—he didn't like what he called "speculative" R&D. And Allergan was everything Valeant wasn't: a highly successful company that had spent $7 billion on R&D between 2003 and 2013.

Pearson, who, over the objections of some in the company, told shareholders his goal was to make Valeant one of the five largest pharmaceutical companies by market value, needed a big deal to get there. The previous year, he had called Allergan C.E.O. David Pyott, 63, who said he had no interest in a deal. A few weeks before making the hostile offer, Pearson called again to set up a meeting, which he

then canceled. A Scottish mountain climber whose smooth exterior masks a steely interior, Pyott didn't worry because he didn't think Valeant, whose debt was already rated "junk," could raise enough money to make a serious offer for Allergan, which had a market capitalization of $37 billion.

"DON'T BET ON SCIENCE—BET ON MANAGEMENT" WAS ONE OF PEARSON'S MOTTOES.

Enter Pershing Square, which, by using "derivatives and other stealth trading techniques," as a lawsuit later alleged, secretly accumulated a nearly 10 percent stake in Allergan. The idea was that Ackman, whose Pershing Square was the largest single shareholder, would pressure Allergan from the inside to sell, and because of his reputation, a "wolf pack" of other investors would line up behind him. Once Valeant prevailed, it would slash Allergan's research-and-development costs by 90 percent, saving billions of dollars and creating immense short-term profits. In addition, Allergan paid taxes at a rate of 26 percent; apply Valeant's far lower tax rate and an additional $500 million would appear.

But Pyott and the board were determined not to sell the company to Valeant. "Everyone who knew Mike Pearson in the industry knew Allergan had to fight that battle," says a former pharmaceutical executive. "The fact is they will demolish the company and destroy long-term value," Jeff Edwards, Allergan's C.F.O., wrote in an e-mail to its bankers. "They will cover this all up within a few years by doing the next deal. We simply cannot allow this value destructing deal to occur."

"Valeant is vile" became the Allergan team's unofficial slogan. At one point, a lawyer asked Pyott if he had come up with it. "Absolutely," Pyott responded. That May, Allergan put together a detailed presentation outlining all the reasons it would never sell to Valeant. The presentation compared Valeant to Tyco, the huge conglomerate that had imploded in a wave of accounting scandals in the early 2000s.

While Valeant and its supportive investors argued that the business showed "organic" growth, meaning the growth wasn't coming just from acquisitions, Allergan argued that much of the apparent growth was because Valeant was hiking the prices of drugs it had acquired. And since Valeant had persuaded investors to use "adjusted" measures of profitability, rather than those calculated according to generally accepted accounting principles, Allergan noted that from 2010 to 2014 the difference between what Valeant said was its cash flow and the official measure was nearly $2 billion. And on and on.

Ackman shot back a furious letter to Pyott and the board. "The bottom line is this: it is time for you to look at yourself in the mirror and ask yourself whether your behavior as a director of Allergan is appropriate and consistent with your long-term personal reputation and the way you would like to be perceived and judged by institutional and retail investors, the general public, and members of your community and immediate family."

But investment bankers, who had long supported Valeant's aggressive acquisition spree, reacted negatively. "The mistake they made is that they thought they would flame us down with invective and personal threats," says a former Allergan executive. Even Goldman Sachs, which had been a major Valeant banker—and had made $212 million in fees doing deals for Valeant since 2000, according to Thomson Reuters—defended Allergan. "People on Wall Street love Pyott," says an investor. "This was as if a dirty drunk attacked your beloved uncle."

A number of the plastic surgeons and dermatologists who did business with both companies were livid, too. After Valeant acquired Medicis, it cut much of the support the company had previously provided. Sales plummeted, partly because Allergan competed fiercely with them, but, as Pyott would joke, "even if you went to your best salespeople and said, 'Destroy the business,' you wouldn't be able to destroy the business the way Valeant did unless you had pissed off a lot of doctors."

At one investor meeting, when Pearson was being pressed on how he would cut Allergan's costs, he told the crowd that Allergan wasted so much money it even had a golf course for executives at its headquarters. But a well-known analyst named David Maris pointed out this simply wasn't true. Allergan had no golf course, and, Maris believed, Pearson's faulty assertion raised larger questions about whether Pearson had a solid plan for the cost cuts he was promising. (Valeant responded at the time to the *Financial Post* that the remarks were taken out of context, though another analyst at the meeting backed Maris's version.)

And there was hypocrisy. Although Pearson bragged about how lean Valeant was, he had unlimited use of Valeant's two Gulfstream jets for business purposes. Pyott, on the other hand, flew commercial, sometimes even coach.

Even ValueAct voted against the proposed deal. When a person close to C.E.O. Jeff Ubben called him to say, "Jeff, sell it to him [Ackman]. The room isn't big enough for the two of you," Ubben responded, "I just can't."

In the end Pyott won by finding a generic-pharmaceutical company called Actavis, based in low-tax-rate Ireland, to top Valeant's bid. But the raiders did not experience an entirely unhappy ending: Due to the increase in Allergan's stock price, Pershing Square made $2.2 billion in profits, and Valeant, which had struck a deal with Ackman to get a share of any profits the fund made, walked away with $287 million in net profits, according to a lawsuit that was later filed over the deal. That year, Pearson was paid an extra $8 million.

But the longer-term ramifications were indisputably negative. The deal raised Valeant's profile, and skepticism about its business model burst into public view. It wasn't just about the Allergan deal. Hedge-fund manager and short-seller Jim Chanos, of Kynikos Associates, best known for shorting Enron, presented Valeant as his best short idea in February 2014. Chanos claimed the company was just another "roll up," dismissive Wall Street slang for a serial acquirer that uses aggressive accounting to hide flaws in its business.

Eugene Melnyk, the former C.E.O. of Biovail, filed a whistle-blower complaint with U.S. regulatory agencies over Valeant's tax structure. "It's a house of cards," he told a Canadian newspaper in August 2014. "It's going to come crashing down on them, I'm telling you. And when it comes crashing down, it's going to happen so fast and so hard that people are going to lose fortunes."

In some ways, it didn't even matter if the skeptics were right. The ugliness of the Allergan fight put a stop to Valeant's ability to use its stock to buy other companies, because no board of directors could sign off on such a deal now that Valeant had been publicly compared to an infamous company like Tyco.

Perhaps the most unexpected postscript, though, was that Ackman put his fund's money where his mouth was and invested all its winnings from Allergan in Valeant. "We greatly admire what you have accomplished and are delighted to be your partners once again," he e-mailed Pearson. It was a huge investment. Pershing Square bought 16.5 million shares at an average price of $196 a share, at a cost of more than $3 billion, which was about 19 percent of Pershing Square's total capital.

Likewise, at Sequoia, fund manager Bob Goldfarb still "thought Michael Pearson was the best deal-maker in the history of the universe and was smart enough to weave his way through everything," according to someone close to the events.

On August 5, Valeant's stock hit a peak of $262.52, meaning that investors had received a stunning 53 percent annual return, according to a calculation performed by the financial-services company Motley Fool. On paper, thanks to the way his compensation had been structured, Pearson's stake was more than $2.5 billion.

HOUSE OF CARDS

But then everything changed. On September 20, 2015, *The New York Times* wrote about a young pharmaceutical C.E.O. and former hedge-fund manager named Martin Shkreli, who had hiked the price of a lifesaving drug more than 5,000 percent overnight. The piece mentioned that Shkreli wasn't alone: when, earlier in the year, Valeant bought a portfolio of products from a company named Marathon, including two lifesaving heart drugs, Nitropress and Isuprel, it had hiked the prices 525 percent and 212 percent, respectively. It did this on the day the deal closed. The day after the *Times* piece ran, Democratic presidential candidate Hillary Clinton tweeted, "Price gouging like this in the specialty drug market is outrageous." In short order, Valeant admitted that it was being investigated by both the House and the Senate, and had received subpoenas from the U.S. Attorney's Offices, in the Southern District of New York and Boston, over its pricing of drugs and its programs to assist patients.

IT WAS INDISPUTABLE THAT PEARSON PRODUCED THE RESULTS HE PROMISED. "YOU CAN'T BET AGAINST MIKE" BECAME A WALL STREET REFRAIN.

N, her sister, K, and others with Wilson's disease weren't the only ones who were being affected by Valeant's tactics. Up to that point in 2015 alone, according to an October report by Deutsche Bank, Valeant had raised prices on 65 prescription drugs by a weighted average of 85 percent, far more than the industry average of 20 percent. Two drugs Valeant sold to treat skin conditions related to cancer had soared nearly 1,700 percent over six years, according to a*JAMA Dermatology* study. For example, a tube of Targretin gel, which treats lesions caused by lymphoma, rose from $1,687 in 2009 to about $30,320 in 2015.

Although Valeant always argued that "gross" prices didn't represent what the company actually received after discounts to insurers, Wells Fargo analyst David Maris, who soon put a "sell" rating on the stock, noted in a report that he dug through the company's financial statements and found that in almost every quarter most of its growth in the U.S. had come from price increases.

In May 2015, Charlie Munger, Warren Buffett's highly respected longtime sidekick, saw "price gouging" from his other vantage point, as chairman of Good Samaritan Hospital, in Los Angeles. He called Valeant "deeply immoral."

Inside Valeant, some other executives worried about "taking price," as steep price increases were known. But Pearson ran the show, and although he'd always said that Valeant would be able to stop using this tactic once the businesses it had acquired hit their stride, he seemed increasingly determined to push every lever he could to generate earnings. Neither his board nor his investors stopped him.

In an investor meeting in the spring, Pearson said that "from your standpoint [raising prices] is not a bad thing," according to a tape recording of the meeting. "The capitalistic approach to pricing is to charge what the market will bear," an analyst at Sequoia told that fund's investors.

When I pushed Ackman on how he could have invested in Valeant, given his well-known stance that a company he is short, Herbalife, wreaks economic havoc on people's lives, he said, "I did not view [Valeant] as an unethical company. I wouldn't have invested in an unethical company." About Pearson, he said, "He thought about it almost like it was a specialty chemical company. He would mark the price to where the therapeutic value was." Ackman said he called the company when he read about the price hikes for Isuprel and Nitropress, and Pearson responded that the drugs were underpriced relative to the value they provided in a very expensive operation. On Cuprimine and Syprine, Pearson argued that, due to Valeant's patient-assistance programs, no one was ever denied the drug because he or she couldn't afford it—and usually insurance paid.

"I viewed it as a commercial battle between for-profit participants," said Ackman, who added that the price hikes were "in retrospect a red flag, but they were always presented to me as a small part of the business."

Nor, according to critics, was Pearson always completely forthcoming about pricing. On an earnings call in the spring, he claimed, "Volume was actually greater than price in terms of our growth." C.F.O. Howard Schiller sent a message correcting him: "Excluding Marathon, price [increases] represented 60 percent of our growth. If you include Marathon price represents about 80 percent." Valeant later clarified that Pearson had been accurate—that is, if you measured only the company's top 20 products and excluded newly acquired drugs. "He was cute with language," says David Amsellem, an analyst at Piper Jaffray, speaking generally about Pearson. "He's so smart that he can create smoke and mirrors to obfuscate the truth. He doesn't need outright lies."

On July 23, Valeant announced profits that topped what investors had been expecting, and raised its forecast for the rest of the year. The stock soared almost $15, to $253.84 a share. A few days earlier, on July 20, Pearson had asked his executives at certain divisions for updated forecasts. A senior vice president wrote back, "Overall, numbers are down . . . . Here is what we are planning. Take a price increase this week . . ."

For Valeant's skeptics, the lack of concern by investors about the price hikes wasn't the only mystery. Chanos kept asking his analysts, "Who is paying for this?" Why weren't insurers saying no? It wasn't just lifesaving drugs such as Syprine and Cuprimine. Investors celebrated a drug called Jublia, which Valeant had developed itself—to treat toenail fungus. By the summer of 2015 it had become Valeant's second-best-selling drug. Skeptics point to a video of an infuriated doctor arguing that Jublia works no better than Vicks VapoRub, yet Valeant was able to charge a stunning list price of nearly $4,900 per toe for a full 48-week course of treatment with Jublia.

Patients, who got coupons from Valeant, often paid nothing and may not have realized what their insurance companies were paying. Was the system really that screwed up? Well, yes. Coupons encourage patients to choose expensive drugs, and so-called "patient-assistance programs," which Valeant touts as making its medicines affordable despite price hikes, provide public-relations cover but often do little to help patients. "Flimsy," N.Y.U.'s Caplan calls such programs. And a consulting firm Valeant hired to help it analyze how much to increase prices noted that drugs for diseases like Wilson's, with tiny patient populations, could be priced at a very high level because the overall amount wouldn't "hit the radar screen" of a payer. Some people at Valeant expected the payers to push back about the price increases. But for a long time they did not.

On October 15, hedge-fund manager John Hempton, another outspoken Valeant skeptic who had sparred with Ackman in the past from his home in Bronte Beach, Australia, sent Ackman a taunting e-mail. He wrote, "I just want to say one word to you. Just one word." It was "Philidor."

Four days later, Roddy Boyd, a financial journalist, explained that Philidor (named after an 18th-century chess champion) was a specialty pharmacy whose main business was dispensing Valeant's drugs to consumers and getting insurers to pay for them. On its face, it wasn't illegal. But Boyd pointed out that Valeant had gone to great lengths to conceal its connection with the pharmacy. And soon, major media outlets, from *The Wall Street Journal* to Bloomberg, published pieces quoting former Philidor employees who said they were told to do things such as change codes on doctors' prescriptions to Valeant's brand, even when much cheaper generics were available, and re-submit rejected claims by using another pharmacy's identification number. (Philidor has said it always adhered to the highest ethical standards.)

"Philidor was used to rip off insurance companies," Hempton says, by which he means that it created more demand for Valeant's drugs than there otherwise might have been, in order to deliver the "organic growth" investors wanted to see. "The maestro knew what his audience was looking for, so he played the orchestra so that we would hear what we wanted to hear," says Anthony Scilipoti.

On Thursday, October 22, with its stock having fallen almost 60 percent to $109.54 from its high of $262.52, on August 5, Valeant wrote that it would hold a call with investors the following Monday to clear everything up. "Every minute that you wait . . . another shareholder capitulates on Valeant and does not come back," Ackman e-mailed Pearson. One investor, Peter Andersen, the chief investment officer of Congress Wealth Management, said he was "virtually certain" that all the questions would be answered, because the company had the weekend to prepare. But on the call, the company wouldn't answer some specific questions about Philidor. Instead, it was setting up a special committee composed of members of its board to investigate.

Andersen immediately sold all his shares. "I thought, If that's the best they can do, there's a lot of fire behind that smoke."

But other investors, including Pershing Square, Lone Pine, Viking Global, and Sequoia, added to their positions. In letters they wrote to their investors, the reasoning was all the same. The aggressive price increases and the use of Philidor were just distractions. Many drug companies used specialty pharmacies (which is true).

ValueAct had sold $1 billion of Valeant stock when it was near its high, before the Philidor revelations, but continued to own 15 million shares, telling its big investors that "we do not cut and run at the first signs of trouble. Instead, we roll up our sleeves and focus our efforts to try to preserve the long-term opportunities at the company."

At Sequoia, there was a call in which independent directors urged the sale of Valeant. Instead, Bob Goldfarb bought an additional 1.5 million shares, making Sequoia Valeant's largest shareholder. Two

independent directors resigned. ("It was Goldfarb," says one person who is familiar with events. "He fell in love.")

Ackman, whose fund bought two million more shares at a price of $108 per share, started firing off e-mails to Pearson. "Perception very quickly becomes reality when reasonable questions remain unanswered," he wrote in one. "While I know that Mike greatly prefers to answer questions one on one with shareholders, the time to do so has run out . . . . As things stand, the torpedoes are in the water and the sharks are circling. They will kill the company." Ackman then held a four-hour call, complete with a 38-page slide deck, to answer all the questions coming from Pershing Square's investors. He pointed out that other big pharmaceutical companies had paid multi-billion-dollar fines for bad behavior and that Valeant could survive a similar punishment. He quoted Warren Buffett, who once said, "Be fearful when others are greedy, be greedy when others are fearful."

"I VIEWED [PRICE HIKES] AS A COMMERCIAL BATTLE BETWEEN FOR-PROFIT PARTICIPANTS," SAYS BILL ACKMAN.

Inside Valeant, Pearson began to tell employees that it would all be fine if they could just quiet the press and stop the skeptics, and soon a similar refrain arose from Valeant's investors. Investor Glenn Greenberg told Bloomberg that the media had conducted a "witch hunt." ValueAct's Jeff Ubben talked to CNBC about "the short-sellers and the media who are dying for some new crisis like Enron." It was as if they all saw the world through the lens of Mike Pearson. "The level of reciprocal loyalty went beyond rationality," says a former Valeant investor.

On Christmas Day, Valeant acknowledged that Pearson had checked himself into a hospital in Morristown, New Jersey. A few days later, he was moved to one in Manhattan. The company said he was being treated for a severe case of pneumonia and would go on medical leave.

The board appointed Howard Schiller, the former C.F.O., as interim C.E.O. But on February 26, Pearson, to everyone's shock, called the chairman, Bob Ingram, to say he was available to come back. There was fierce argument on the board about whether he should, and when the board said yes, Schiller said he would resign from the board. (At the urging of Ingram, he ultimately remained.) At a town-hall meeting with Valeant's senior managers the following week, Pearson, who had been near death in the hospital, appeared skinnier and walked with a cane. He denied rumors that he had been in rehab, according to someone who was there, and said there weren't any other big issues to bedevil the company.

That was only the start of a surreal chain of events that made a mockery of any pretense that Valeant was well managed. On Monday, February 29, Valeant canceled a call it had scheduled for that morning to discuss 2015's fourth-quarter results, disclosed that it wouldn't be able to file the previous year's financial report due to accounting problems with Philidor, scrapped the guidance it had previously provided to investors for 2016 profits, and disclosed that the S.E.C. was investigating it. (The last disclosure came only because Probes Reporter, which specializes in finding S.E.C. announcements, had figured it out.) Valeant scheduled a call with analysts, presumably to reassure them about the business, but then abruptly canceled it "due to media interest."

Pearson began privately calling his big investors. Valeant was expected to earn more than $7 billion under its definition of profits that year. "The board allowed him to go out and tell people, 'There are things we need to pencil out, but there aren't any big changes,' " says an investor who spoke with Pearson and got the impression profits would be down by only a few hundred million dollars.

Then came a disastrous conference call on March 15. Prior to the call, the company disclosed that a key measure of profit was expected to be drastically lower than anyone had expected—down to around $6.2 billion to $6.6 billion. But during the call a somewhat discombobulated Pearson put the figure at $6 billion. When an analyst confronted Pearson about the discrepancy, he said he and the board had had "a lot of debate" about the numbers. That was true.

Valeant also disclosed that its inability to file its reports could result in breaches of the terms governing some of its $30 billion of debt. The stock closed down more than 50 percent, at $33 a share. Ackman's Pershing Square lost more than a billion dollars. "That a stock could go from $230 to $30 in a matter of months in and of itself tells you that no one knew what was going on," says Scilipoti.

A week later, in a long-weekend board meeting, Ackman, who had come to believe there were what he calls “serious cultural issues” at the company in terms of the pressure to produce earnings, argued that Pearson had to go. On March 21, the company announced he would leave and that Ackman would join the board. In addition, while the board’s audit committee had previously signed off on Philidor’s accounting, the board asked Schiller to resign, claiming that his “improper conduct” had contributed to the accounting error with Philidor. Schiller refused to play the scapegoat and insisted that he had engaged in no improper conduct. “We interpret this morning’s apparent overflow of deadly Board politics as further evidence of continuing massive leadership dysfunction and misguided decision-making that took the company down,” wrote a research firm called Gimme Credit.

For everyone involved, the future is unclear. According to filings, Pearson stands to make between $11 million and $18 million this year based on the terms of his severance, Valeant’s performance, and his assistance with the transition to a new C.E.O. (Pearson’s stock in the company is still worth around $200 million.) But as someone who knows him well says, “Mike’s life and death is Valeant.”

At a congressional hearing called by the Senate Special Committee on Aging, which is investigating price hikes, Pearson said, “Valeant was too aggressive—and I, as its leader, was also too aggressive—in increasing the prices of some of our drugs.” But he also said, “My cumulative public comments have left the misimpression that shareholder interests were my only focus as C.E.O. of Valeant. That is absolutely not the case.”

Ackman, who also testified, said, “Clearly [there] were things I did not understand about the business and that was a failure of due diligence on my part.” But he still thinks he can save the company. He and other investors believe that the price jacking that has come to define Valeant was just at the fringes, a function of Pearson’s need to increase the value of the stock by any means available, and that Valeant has strong core businesses that aren’t dependent on price hikes or captive distribution channels such as Philidor.

Ackman and others at the company helped persuade Valeant’s debt holders to waive the covenants on their loans, and in late April the company announced the hiring of a new C.E.O., Joseph Papa, who had previously led a pharmaceutical company called Perrigo. Papa’s compensation package includes stock and options that will be worth almost half a billion dollars if he can get Valeant’s stock back up to $270. Many of the company’s board members are expected to be replaced with people from the traditional pharmaceutical industry. But skeptics point to a mountainous $30 billion of debt, a tax structure that may not survive a close look, a total inability to make acquisitions, and intense scrutiny of its pricing from all the insurers.

THE ENTIRE INVESTMENT COMMUNITY IS SHAKEN; THE CONCEPT OF SMART MONEY SEEMS SPECIOUS.

The entire investment community is shaken; the concept of smart money seems specious. Chanos has a new saying at his fund: “Most of these guys are all about financial engineering, not financial analysis.”

One of the biggest losers is Sequoia, where Goldfarb stepped down in March. Investors have pulled nearly $800 million from the fund, and some have sued, alleging that Sequoia’s huge investment in Valeant is “akin to a gambler at the race track betting more than one quarter of his net worth on a fast horse with a history of maladies and with improbably high odds.”

If you were an optimist, you’d say that now everything has changed. The government has made it much harder to do tax inversions, and the Senate Special Committee on Aging is focused on the issue of drug pricing. At the hearing, Ackman said he had recommended an overall 30 percent volume-based price cut in Nitropress and Isuprel.

But apart from the arm waving, little *has* actually changed. Erin Fox, the head of pharmacy services at the University of Utah, also testified at the Senate hearing and says neither she nor anyone she knows has seen any evidence of the supposed volume-based discounts for Nitropress and Isuprel. Valeant subsequently said hospitals would get a volume-based discount of at least 10 percent and as much as 40 percent, but it remains to be seen whether, and how, the program will be implemented.

As for Cuprimine and Syprine, most analysts laugh when I ask if the prices are going to be decreased. And when investors defended Valeant's actions by saying everyone in the pharmaceutical industry raised prices, just more surreptitiously, well, that is true.

J has a solution. He says that if a drug's price is increased by a certain amount, Congress should mandate that the F.D.A. approve a generic quickly or allow importation of that drug from cheaper overseas sources. "For once, patients win," he says. "And you win too because, like I've said, your family is paying for all this, too."

Maybe Congress will do something like that. But, for now, we live in a world where investors' demands for more and more profits, and executives' compensation for the same, override any sense of right and wrong. We pretend that it's a free market, when the reality experienced by patients like N and K is that they have no choice whatsoever—unless, that is, they choose to die.

FULL SCREEN

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