| This 3DAdvisors Report Covers: |
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| ✓ **Insider Trading**: Insider Trading Behavior |
| ✓ **Accounting**: Quality of Earnings Issues |
| ✓ **Governance:** Corporate Governance Issues |

# Governance and Insider Selling Are Lead Concerns
# Mylan Laboratories Inc. (NYSE:MYL)

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Mylan Laboratories Inc. is engaged in developing, licensing, manufacturing, marketing and distributing generic and brand pharmaceutical products. The Company conducts business through its generic and brand pharmaceutical operating segments. The Generic segment consists of two principal business units, Mylan Pharmaceuticals Inc. (Mylan Pharm) and UDL Laboratories, Inc. (UDL), both of which are wholly owned subsidiaries. The Brand segment consists of two principal business units, Bertek Pharmaceuticals Inc. and Mylan Tech, both of which are wholly owned subsidiaries. Bertek's principal therapeutic areas of concentration include neurology, dermatology and cardiology.

## Summary of 3DAdvisors Findings for MYL

- **Governance:** Related party issues are broad and complex
- **Governance:** Board does not meet most standards for independence
- **Insider Trading:** Lack of options disclosure and a pick up in selling
- **Accounting:** "Rebate" treatments merit close scrutiny

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## Discussion of 3DAdvisors Findings

We have been monitoring executive behavior at Mylan Labs for over a year as a series of related party dealings has held our interest. Recently, however, as the shares weakened after the October 29th Q2 release, an extension of insider selling that had begun last summer caused us to turn up our focus on the Company. These sales, into a stock price decline, come at a time when the Company has been fighting off both concerns related to a major patent infringement matter with J&J and the challenges of increasing competitive pressures on the Amnesteem product which was introduced in May of 2003. The J&J matter affects Mylan's release of the generic product Duragesic. Speculation that Mylan may lose its argument, delaying the Duragesic product release, caused the stock price, which had fallen 14% from its late-October $28 peak to drop another 16% (to $20) before recovering. During this time, Mylan reaffirmed its EPS guidance for 2004 but refused to provide any supporting detail concerning revenues.

Some of the initial Duragesic concerns seemed to ease later in November when it became known that Mylan might have found a technical loophole in the J&J case. This development has helped the stock price move back up to its current $25 level. The fact that insider selling at Mylan has been historically high lately, and that a good amount of it occurred as the shares began trading lower, dovetails with our governance concerns about the Company, making Mylan, in our opinion, a higher-risk candidate than it had been earlier this year.

<u>Governance: Related party issues are broad and complex</u>

The related party story at Mylan unfolds with a series of management changes as a backdrop that began back in November of 2000 when Mylan announced that its CFO, **Donald M. Schilling**, had resigned. Schilling left on 60 days notice and was succeeded by **John M. Hanson**, who had been CFO of an Ivax subsidiary. Hanson's tenure was a short one. In June of '01 he, and COO **Richard Mouldin**, "voluntarily" resigned amid "differences of opinion surrounding matters of corporate culture".

Mylan brought former executive, **Clarence Todd** out of retirement to become interim President and COO and made **Gary Sphar** (V.P. of Mylan Pharmaceuticals) the interim CFO. Sphar relinquished the CFO position when current CFO **Edward Borkowski (43)** was hired in March of '02. (from Pharmacia). Sphar remained with the company and was named V.P. Corporate Controller in July of '02.

In an interesting changing of the guard, **Robert Coury (41)**, who had been on Mylan's board (as well as one of the Related Party interests mentioned below) was named as successor CEO to outgoing Mylan Puskar (Mylan co-founder). Mylan then elevated **Louis DeBone (56)** to President and COO, replacing Clarence Todd who, along with Mylan Puskar, remains on the Mylan board.

Borkowski, Sphar, Puskar, Debone and Todd are all counted among the list of recent insiders selling Mylan's shares (see below).

CEO Coury is an interesting story. Before his appointment, but at the same time he served on Mylan's board, Coury owned a consulting firm. The firm was getting $75,000/mo. from Mylan, plus bonus payments, and had received options for 100,000 shares of Mylan stock that were exercised in January of '02, one month prior to Coury's appointment to the Mylan board. Total fees to this firm, from Mylan, totaled $1.57 million in F/Y '02 and $380,000 in F/Y '03. In addition, Mylan had agreed to pay one tenth of one percent of the aggregate value of "any major business transaction" in which the consultant participates and which is announced during the term of the agreement or within 12 months of its termination. Upon Coury's appointment as CEO in July of '02, the consulting agreement was terminated. No mention from the Company, however, as to whether Coury was paid any of the royalties that may have been associated with "any major business transaction".

Coury's package, upon terminating the consulting agreement and coming on board as CEO, was impressive. On top of his base annual salary of $900,000, he is entitled to a guaranteed bonus of another $900,000 annually. This guaranteed bonus continues until his contract expiration in 2007. On top of this, he received an additional

$900,000 discretionary bonus in F/Y 2003. The Mylan proxy explains only that the discretionary bonus was based on "subjective factors such as Mr. Coury's leadership and guidance". The fact that there was no effort at further justification continues to intrigue us. In addition, Coury was granted options for 1.35 million shares (adjusted for the recent 3:2 split). One third of these options were exercisable immediately, then one-third per year. Based on our observations over the years, two-year vesting schedules such as these are practically unheard of. If this all wasn't enough, once in place as CEO, Mylan retained the services of Coury Investment Advisors Inc (CIA), which is 100% owned by two brothers of Coury. Mylan and CIA entered into an agreement whereby CIA is paid $100,000 annually plus a yet-to-be-disclosed bonus.

Other related party dealings are no less interesting. A Mylan officer is a consultant to and a minority shareholder of a company that provides "services related to biostudies" performed by Mylan. The agreement, between Mylan and the company, expires in 2010 and provides for a payment of a minimum monthly fee of $125,000, which is to be applied to the services performed. In addition, this same officer (name not disclosed) is a director of a company that performs registry services for a product marketed by Mylan. This officer's son is the owner of the company. The agreement, between Mylan and this company, expires in 2006. In addition, this officer is an investor in a company that provides on-site medical units to "certain subsidiaries" of Mylan. His son is also a principal officer in this company.

A Mylan director, **Douglas Leech** (who chairs Mylan's audit committee) is the CEO of a bank where Mylan has $10.5 million (5% of Mylan's total deposits) on deposit with on 3/31/03, up from $7.5 million in 2002.

Another director of the company, **Stuart A. Williams (48)**, became Mylan's Chief Legal Officer in March of '02. He was an attorney with a law firm (DKW Law Group) where, until recently, he practiced. This firm provided legal services to the Company totaling $6.3 million in F/Y '02 and $3.3 million in F/Y '02.

Mylan also holds an equity interest in a supplier to which it paid $3.7 million and $18.3 million respectively (F/Y 2003 and F/Y 2002) for raw materials used for production. Mylan also pays this supplier royalties under a product licensing agreement that totaled $3.7 million in F/Y '03.

## Governance: Board does not meet most standards for independence

By this time it should be of little surprise that Mylan's board falls short of any reasonable measure of independence. More than half of the board (six of eleven) does not fit the standards of independence set by Governance Metrics International (GMI):

**Mylan Puskar** – Company Chairman, is not only former CEO but also receives $200,000/year annually as Chairman's salary and, more importantly, $1 million per year in retirement benefits for the rest of his life.

**Douglas Leech** – Chairman of both the Audit and the Compensation and Nominating Committees, Leech is CEO of Centra Bank Inc., where Mylan has $10.5 million in deposits.

**Robert Coury** – Current Mylan CEO.

**Patricia Sunseri** – Senior V.P. Investor and Public Relations for Mylan.

**Clarence Todd** – Employed by Mylan between 1970 and his retirement in 1999.

**Stuart Williams** – Chief Legal Officer at Mylan.

In addition to this, it is apparent that only one member of Mylan's five-member Audit Committee, Douglas Leech (who is not considered an "independent director" by GMI standards), has any visible financial background.

Insider Trading: Lack of options disclosure and a pick up in selling

This lack of board independence, coupled with Mylan's proclivity for related party dealings, creates a culture that is suspect in many ways, not the least of which may be insider behavior, where key disclosures are absent. Most significantly, there is a lack of clear disclosure with regard to vesting schedules. We can normally get information from proxies and Form 4s, but not from Mylan. We have seen few companies going to such lengths to obfuscate such detail. This makes it very difficult to assess the true magnitude of holdings reductions when insiders are selling. Nevertheless, we find the pattern of insider selling, which began in 2003, to be important since, until then, insider selling had been just a trickle for the past five years. We consider the pace, which accelerated in August and has continued through November, to be an important signal, especially given the fact that selling has remained strong even in the face of recent declines in Mylan's shares.

Furthermore, the fact that a number of these sellers were doing so back in August can indicate that the potential timing of any related event is closer than if they all had just begun selling in November. Insiders typically do not sell just prior to major events or news or they run the risk of insider trading charges.

All the figures listed below reflect the recent 3 for 2 split in Mylan's shares. Also, the holdings reductions quoted are the "actionable holdings" of the insiders involved. By this we mean all common stock plus exercisable options. Given Mylan's propensity for obfuscating detail on option vesting schedules, we are being conservative in our reduction estimates below:

- **John O'Donnell (57)** – Chief Scientific Officer. O'Donnell followed up a February sale of 45,000 shares (his first sale since originally filing as an insider back in 2000) with November sales totaling 180,000 shares at prices in the $24 range. The sale reduced his holdings by 20%. His sale occurred on November 3rd, as the window for selling following the Q2 release opened and the shares had already trimmed 14% from their highs.

- **James Mauzey (54)** – Senior V.P. President of Bertek Pharmaceuticals Inc. Where Mauzey waited until the 11th of November to sell 50,000 shares, he still got the same price, $24. Mauzey, who had not been on record for selling for five years, has now sold after each of the past three releases, dropping a total of 179,275 shares, or 34% of his holdings.

- **Louis Debone (57)** – President and COO. Debone sold as soon as the November window opened, clearing out 135,000 shares at prices just below $24. These are his first sales on record and dropped his holdings by 10%.

- **Sharad Govil (47)** – President, Mylan Technologies. Prior to this year, we have no record of Govil's having sold shares. After each release this year, however, he has done so. The most recent November sale occurred on the 26th, as Mylan's shares had recovered a bit from the lows. Govil got just under $26 for his 2,000-share sale. So far this year, he has cleared out of 35,600 shares. Govil holds no common shares, choosing to keep his position in options. Given the lack of vesting schedule detail at Mylan, it is difficult to estimate his holdings reductions this year.

- **Clarence Todd (69)** – Director. Todd's August sale of 150,000 shares at about $23 each was his largest-ever by far. He dropped his holdings by 15% in doing so.

- **Laurence Delynn (78)** – Director. Delynn sold 150,000 shares in August at prices in the $22 to $23 range. The sales trimmed his holdings by 20%.

Other sellers, since August, in Mylan's shares include CB Mylan Puskar (251,250 shares in August) and Director John Gaisford (91,125 shares in August), and Controller Gary Sphar (4,500 shares in August).

Accounting: "Rebate" treatments merit close scrutiny

It's certainly no secret that Mylan, like its peers, engages in a number of industry practices with regards to certain rebate issues:

- **Price Adjustments:** Mylan also refers to these as "Shelf Stock Adjustments". They are credits issued to reflect decreases in the selling prices of products that are on distributor shelves at the time of the price reduction. Mylan states that the amounts recorded for estimated shelf stock adjustments are based upon "specified terms with direct customers, estimated launch dates of competing products, and estimated declines in market price and estimates of inventory held by the customer".

- **Rebates:** Treatment is straightforward here.

- **Chargebacks:** Mylan discloses that "the provision for chargebacks is the most significant and most complex estimate used in the recognition of revenue." Chargebacks occur when Mylan markets products indirectly to independent pharmacies, managed care organizations, hospitals, nursing homes and pharmacy benefit management companies. Mylan enters into agreements with these indirect customers to establish contract pricing for certain products. The indirect customers then independently select a wholesaler from which to actually purchase the products from at these contracted prices. Mylan then provides credit to the wholesaler for any difference between contracted price (with the indirect customer) and the wholesaler's invoice price. This credit is the Chargeback.

It is easy to see how much subjectivity is involved in some of these practices. More interesting though, is the treatment that Mylan utilizes in order to provision for these items. Instead of establishing a liability account, or by reducing the revenue amount, Mylan nets these amounts against gross A/R's. What catches our eye is the magnitude of the amount of the Allowance for these items. Mylan's recent 2003 Q2 10Q, for instance shows A/R's on the Balance Sheet at $232.5 million. This amount however, is net of allowances (for the above provisions) of $297.4 million. Consequently, Mylan's A/R figures are understated and tend to render any calculations for DSO's difficult to interpret. Indeed, at year end F/Y 2002, Mylan's booked A/R amount was $187.6 million, which was net of Allowances totaling $283 million. So, at F/Y 2003 end Mylan's Allowances were running at about 60% of gross A/R's. By the end of Q2, 2004 the same allowance represented 56% of gross A/R's. This increase amount of booked A/R's net of Allowances caused DSO's to jump from 51 to 58 days. The subjectivity involved in the application and adjustment of these huge allowances creates plenty of room for earnings management.

A look into the Cash Flow Statement illustrates this. The changes in estimated sales allowances represent significant items in the Statement. In the fiscal years ended March 31, 2003, 2002 and 2001, the change in estimated sales allowance was $79.9 million, $95.7 million and $34.3 million respectively. These were all apparently charges to expense and, as a result, have been represented as non-cash items and added back to net income in Cash from Operations. The changes represented 6% of revenues in 2003, 9% in 2002 and 4% in 2001. In the two most recent of the three years, these allowance-related charges exceeded Selling and Marketing expenses.

Why such a huge amount of uncollectible revenue is treated as expense rather than, as reduced, or even deferred, revenue remains unclear. If one assumes that the amount of the increase in the allowance relates to current year revenues, which seems a logical assumption, it would seem that the case could be made that the amounts never should have been put in revenues at all. If this were all done properly, that is to say if everything were kept in the appropriate period, the bottom line would not change. The catch here is that if the recorded change is used to move income between years, the story becomes quite a different matter.

We wonder if this is why Mylan management confidently reiterated its guidance in November, when the shares were under pressure, but when pressed for details would not provide them. This is consistent with other practices by the company with regards to stating financial goals: they simply don't state them other than to provide basic EPS guidance or to say that they manage the company in order to maximize shareholder value.

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