CEO PAY AT VALEANT

DOES EXTREME COMPENSATION CREATE EXTREME RISK?

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APRIL 28, 2016

INTRODUCTION

The litmus test for an effective executive compensation program is whether it provides incentive to attract, retain, and motivate qualified executives to pursue corporate objectives that build shareholder wealth. This concept, known as "pay for performance," reflects the degree to which executive rewards are correlated with financial outcomes that benefit shareholders. Companies typically encourage pay for performance by offering a mix of cash, equity, and other awards that pay off with the achievement of key performance targets across both short- and long-term horizons.

While the concept of pay for performance is straightforward, the optimal structure is not. The board of directors—and compensation committee in particular—must make a series of decisions about pay design that involve real tradeoffs, including whether to tie pay more closely to operating or stock price results, the balance between financial and nonfinancial targets, the balance between cash and equity awards, the size of awards, and whether allowances should be made for executives who miss targets because of economic factors outside of their control.

The board must also consider the *unintended* consequences of pay, including whether it encourages decisions, actions, or behaviors that are not in the interest of shareholders—such as excessive risk-taking or artificial moves to boost the value of awards.[1] The research literature provides substantial evidence that these types of outcomes can occur. For example, Coles, Daniel, and Naveen (2006) find that executives respond to stock option grants by taking actions to increase firm risk.[2] Armstrong, Larcker, Ormazabal, and Taylor (2013) find that an increase in the sensitivity of CEO wealth to stock price volatility is positively associated with financial misreporting.[3] And Larcker, Ormazabal, Tayan, and Taylor (2014) demonstrate a significant increase in risk-taking incentives among banks prior to the financial crisis, particularly banks that originated and distributed the securitized assets central to the crisis.[4] As a result, executives holding compensation awards whose value is tied to stock price volatility or that pay out only in the case of extreme performance likely require especially vigilant oversight by the board.[5]

CEO PAY AT VALEANT

J. Michael Pearson was recruited as chairman and CEO of Valeant Pharmaceuticals in 2008 by hedge fund ValueAct. ValueAct was the company's largest institutional investor, holding a 16 percent stake and a seat on the board. ValueAct had acquired its position after a late-stage trial of a promising hepatitis C treatment was shown to be ineffective, precipitating a 20 percent drop in the company's share price.[6] ValueAct believed that in-house research for new drug development was not a cost-effective method for drug discovery—a belief that Pearson, previous head of the global pharmaceutical practice at McKinsey & Co., shared. The two favored an approach of allowing outside research groups to identify promising treatments and only acquiring those that offered favorable risk-reward characteristics. The company also looked for situations of untapped pricing power in existing drugs. According to a board member, "We [the industry] fail more often than we succeed. Rather than invest in a high-risk bet, we will be smart through acquisition and licensing."[7] According to Pearson, "There have been lots and lots of reports… talking about how R&D on average is no longer productive. I think most people accept that. So it is begging for a new model and that is hopefully what we have come up with."[8]

ValueAct was also influential in designing the compensation package offered to Pearson—one that encouraged a focus on long-term value creation. Pearson received a $1 million salary and package of equity awards (stock and options) valued at $16 million (see Exhibit 1). Included in these were performance stock units that would vest only upon achievement of the following three-year compounded total shareholder return (TSR) targets:

- 3-year TSR < 15 percent per year, zero shares vest.
- 3-year TSR of 15 percent to 29 percent, 407,498 shares vest (base amount).
- 3-year TSR of 30 percent to 44 percent, 814,996 shares vest (double the base amount).
- 3-year TSR > 45 percent, 1,222,494 shares vest (triple the base amount).

The performance units were structured to offer an exponential payout for exceptional long-term share price performance and zero payout if base-level thresholds were missed (see Exhibit 2). Similar awards were granted to other senior executives. Pearson was also required to purchase $5 million in Valeant stock with his personal money.

Compensation experts lauded the structure. According to one, "[Performance-based awards] go a substantial distance toward addressing my concerns about executive pay arrangements." To another, "Many companies would benefit from imitating this or moving in this direction. More pay for performance is a good thing." He noted, however, that "it creates some incentive to jack up the stock price in year three to hit these hurdles."[9]

Pearson moved aggressively to reshape the company. He reduced the research and development budget, slashed corporate overhead, and launched a string of acquisitions and licensing deals to bring in new products (see Exhibit 3). In 2010, Pearson purchased Canadian-based Biovail in a corporate tax inversion that permanently reduced the company's tax basis. (According to Pearson, "We were able to get a corporate tax structure which took our effective tax rate from 36 percent overall to what was actually 3.1 percent, which we hope to continue to work on and move lower."[10]) In 2012, he acquired Medicis Pharmaceutical for $2.6 billion, in 2013 Bausch & Lomb for $8.7 million, and in 2015 Salix Pharmaceuticals for $11 billion. Corporate revenue grew 10-fold in six years, and Valeant stock price soared (see Exhibit 4).

After 2 years, Valeant stock price exceeded the highest price target for the maximum number of performance units to vest. The board renewed and extended Pearson's contract. Pearson received additional performance units, this time with a four-year vesting term and a maximum payout of 4-times the target number of awards for 60 percent compounded TSR. The board added multiple measurement dates to protect against short-term run ups in the company's stock price. Pearson also agreed not to sell vested shares.[11] At its peak, Pearson's stake in the company exceeded $3 billion in value (see Exhibit 5).

Valeant's fortunes began to turn in 2014, when the company made an unsolicited offer to acquire Allergan (maker of Botox) for $46 billion, or $153 per share. Allergan's board rejected the offer as undervalued. Valeant subsequently raised its bid to $166, $179, and then $186 per share. Allergan's board rejected these offers and, amid legal and proxy battles, agreed to be purchased by Ireland-based Actavis for $219 per share.

Although unsuccessful, the hostile battle drew renewed scrutiny to Valeant's business practices. According to a competitor, "Valeant will eventually run out of things to buy and once it does, it faces the problem of how does it keep on the trajectory. A company without R&D short-term and mid-term can be viable, but long-term is not."[12] Some noted the significant mismatch between reported (GAAP) and adjusted (non-GAAP) earnings.[13] While the company claimed nearly $8 billion in profit on a cash-basis over a 7-year period, generally accepted accounting principles showed zero net income over this period. Cash flows also significantly lagged adjusted earnings.[14] The company attributed the differences to amortization and impairments of intangible assets, write offs for in-process R&D, and other acquisition and restructuring related charges. Because acquisitions were made in cash, the company carried a large debt load relative to assets and earnings (see Exhibit 6). A former industry executive asked, "Is the role of leading large pharmaceutical companies to discover lifesaving drugs or to make money for shareholders through financial engineering?"[15]

In 2015 and 2016, the company faced a series of setbacks that drove down its stock price. The U.S. Congress inquired about Valeant's drug pricing practices, including increases of the prices of certain cardiovascular, dermatological, and ophthalmological products by as much as 20-fold following their acquisition.[16] The company came under fire for not fully disclosing the extent of its relationship with specialty pharmacy Philidor, which it relied on to fill key prescriptions and guide patients and doctors through the reimbursement process.[17] The board of directors conducted an internal review of the company's reported financials. Although revisions were minor, Valeant was forced to delay the release of its financial statements, lower future earnings guidance, and enter discussions with lenders to ease financial covenants. Rating agencies downgraded the company's debt. Pearson went on medical leave for severe pneumonia, and following his return, the board announced he would step down. Valeant's stock, which peaked at $260, fell 90 percent to $30.

Valeant named Joseph Papa, former CEO of drug maker Perrigo, to replace Pearson. He was granted a compensation package similar in structure to Pearson's, including approximately $30 million in performance share units subject to four-year vesting and multiple performance hurdles. If he achieved the maximum performance hurdle (compound annual TSR of nearly 70 percent), Papa stood to receive $500 million. The maximum hurdle was set to coincide with the company's previous all-time high stock price (see Exhibit 7).[18]

WHY THIS MATTERS

1. Critics of executive compensation often claim that CEO pay packages are not sufficiently tied to stock price performance. At the same time, research evidence suggests that significant

executive exposure to equity awards can produce unanticipated or undesirable behaviors. How can shareholders tell whether the right balance has been struck?

2. An executive who receives an aggressive compensation plan is given incentive to make very risky investment decisions to increase the probability of earning large future rewards. This behavior might be desirable for shareholders if the expected cash flows from these investments substantially exceed the risk incurred. However, it is also possible to impose so much compensation risk on executives that they engage in speculation or other activities that are likely to have an expected *negative* impact on shareholders. How does the board evaluate whether the executive incentives are encouraging decisions that harm shareholder value? Do boards increase their vetting of proposed strategic investment when executives have an especially aggressive compensation plan?
3. Pearson's compensation package contained many elements that shareholders and directors consider "ideal" in compensation design: stock purchased with the CEO's personal wealth, a mix of restricted and performance-based grants, and provisions that required him to hold shares many years past vesting. As illustrated in Exhibit 5, there was almost a perfect correlation between changes in shareholder wealth and changes in Pearson's wealth (i.e., complete pay-for-performance). Was Pearson's compensation design flawed? To what extent were the problems that occurred at Valeant directly a result of the incentives placed on Pearson? Would they have occurred if the incentives were less aggressive?
4. The performance stock units granted to Pearson's had a single performance measure: compound total shareholder return over a three-year hurdle. Should the board have included operating-based or non-financial performance measures as well? Do multiple performance measures provide better alignment between CEO and shareholder interests or unnecessary complexity? Which is the better measure of long-term results: accounting measures or stock price?
5. Valeant's unsolicited takeover of Allergan cast scrutiny on the company's operating and financial tactics. However, those practices had been in place, and well publicized, since the beginning of Pearson's tenure. Did the board, shareholders, and the public fail to identify red flags that should have warned them that the company's approach was not sustainable? Did the stock's extremely positive performance make them complacent in their oversight?
6. Pearson's replacement received a compensation package similar in structure to his predecessor's, with similarly aggressive performance hurdles. Was the board correct to replicate these performance features? Should pay design have been different, given the company's current situation? ■

[1] Examples include manipulating accounting results, manipulating the timing of equity grants to increase their intrinsic value, manipulating the release of information to the public to correspond with more favorable grant dates, and using inside information to gain an advantage in selling or hedging equity awards.

[2] Jeff L. Coles, Naveen D. Daniel, and Lalitha Naveen, "Managerial Incentives and Risk-Taking," *Journal of Financial Economics* (2006).

[3] Christopher S. Armstrong, David F. Larcker, Gaizka Ormazabal, and Daniel J. Taylor, "The Relation Between Equity Incentives and Misreporting: The Role of Risk-Taking Incentives," *Journal of Financial Economics* (2013).

[4] David F. Larcker, Gaizka Ormazabal, Brian Tayan, and Daniel J. Taylor, "Follow the Money: Compensation, Risk, and the Financial Crisis," Stanford Closer Look Series (September 8, 2014).

[5] For example, the board might ask deeper questions about strategic investments. For a review of the research literature on compensation and risk, see David F. Larcker and Brian Tayan, "Compensation and Risk," Quick Guide Series: Research Spotlight (2015), available at: http://www.gsb.stanford.edu/faculty-research/publications/compensation-risk.

[6] "Valeant Hepatitis C Drug Misses Goal, Shares Dive," *Reuters* (March 21, 2006).

[7] Jonathan D. Rockoff, "Drug Firm Leaves R&D to Others—Valeant Pharmaceuticals Prefers to Forgo the Risk, Grow Through Acquisitions," *The Wall Street Journal* (March 2, 2009).

[8] Andrew Ross Sorkin, "Do Drug Companies Make Drugs, or Money?" *The New York Times* (June 3, 2014).

[9] Joann S. Lublin, "Valeant CEO's Pay Package Draws Praise as a Model," *The Wall Street Journal* (August 24, 2009).

[10] Sorkin, "Do Drug Companies Make Drugs, or Money?"

[11] Valeant Pharmaceuticals, Form 8-K filed November 30, 2009.

[12] Jonathan D. Rockoff and Dana Mattioli, "Valeant's Effort: Build It or Buy It? Drug Bid Puts R&D in Focus," *The Wall Street Journal* (June 11, 2014).

[13] See also David F. Larcker and Brian Tayan, "Pro Forma Earnings: What's Wrong with GAAP?" Stanford Closer Look Series (August 20, 2010).

[14] Researchers commonly measure earnings quality using the metric abnormal accruals. Generally, abnormal accruals represent the different between net income and cash flow. When a large discrepancy exists between these two figures during a sustained period of time, the company's accounting is considered to be lower quality because the company is systematically reporting more net income than it is generating on a cash basis. Research has shown that large abnormal accruals are correlated with an increased likelihood of future earnings restatements. This correlation is somewhat modest but still significant. See Messod D. Beneish, "The Detection of Earnings Manipulation," *Financial Analysts Journal* (1999).

[15] Sorkin, "Do Drug Companies Make Drugs, or Money?"

[16] "U.S. Senate Panel Probing Valeant, Turing over Drug Costs," *Reuters* (November 4, 2015).
[17] Caroline Hunter, "Valeant Shares Plunge on Short-Seller Scrutiny of Pharmacy Revenue," *Reuters* (October 21, 2015).
[18] Valeant Pharmaceuticals, Form 8-K filed April 27, 2016.

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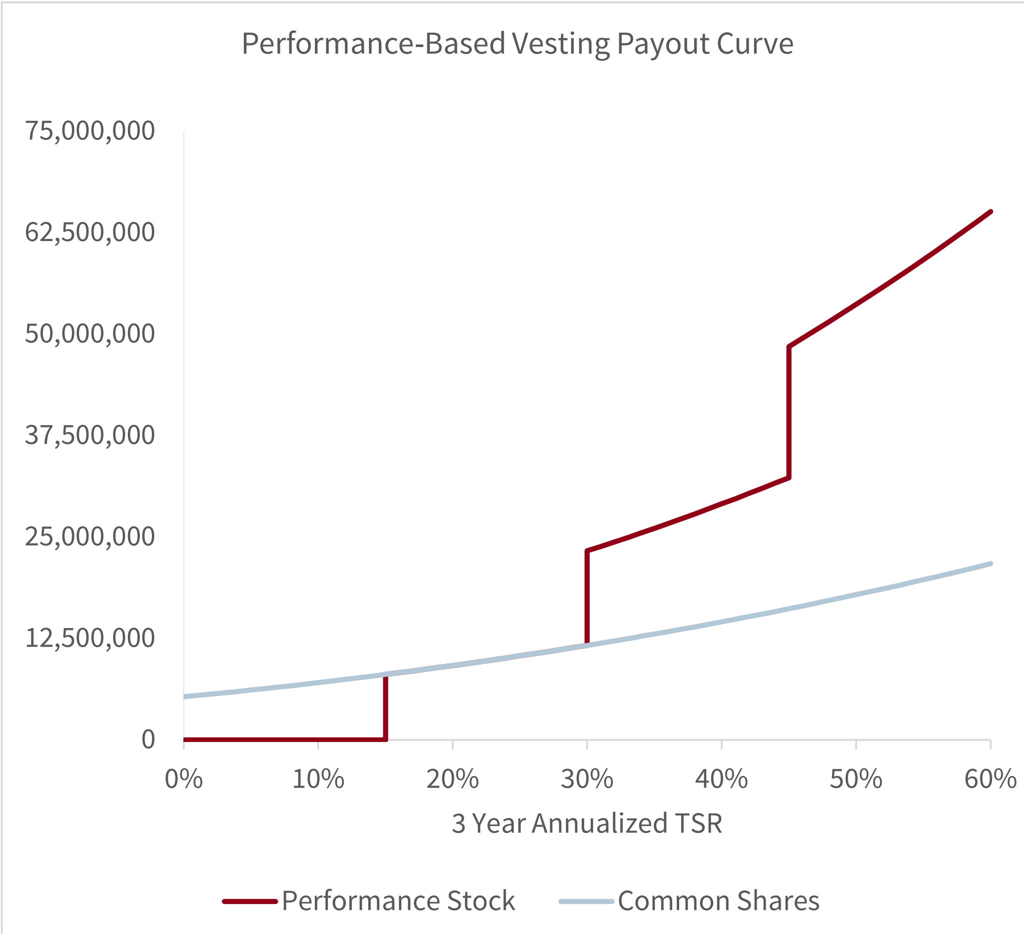
EXHIBIT 1 — VALEANT PHARMACEUTICALS: SUMMARY COMPENSATION TABLE

	Year	Salary	Bonus	Stock Awards	Option Awards	Non-Equity Incentive Plan	All Other Compensation	Total
J. Michael Pearson Chairman and CEO	2014	$ 1,907,693	$ -	$ -	$ -	$ 8,000,000	$ 368,235	$ 10,275,928
	2013	1,750,000	-	-	-	4,789,531	458,203	6,997,734
	2012	1,712,500	-	-	-	3,827,056	573,419	6,112,975
	2011	1,578,462	-	12,168,384	6,015,000	2,996,825	13,951,315	36,709,986
	2010	387,500	-	3,606,966	-	750,000	10,867	4,755,333
	2009	1,000,000	1,000,000	14,868,689	5,081,800	2,000,000	96,966	24,047,455
	2008	916,667	-	11,647,510	4,980,025	1,000,000	138,465	18,682,667

Notes: $1,000,000 bonus in 2009 represents a special payment paid to Pearson upon execution of the first amendment to his employment agreement. Stock awards represent the GAAP fair value of restricted stock and performance stock units as of the grant date. Non-equity incentive plan represents the value of cash bonuses earned in the previous year and paid in the reported year. Immediately prior to the acquisition of Biovail, shareholders of Valeant were entitled to a special dividend valued at $16.77 per share; the $13,951,315 other compensation payment in 2011 represents the dividend equivalent owed to Pearson under his outstanding performance stock units in conjunction with the acquisition.

Source: Valeant Pharmaceuticals, Forms DEF-14A filed with the SEC.

EXHIBIT 2 — VALEANT PHARMACEUTICALS: PAYOUT CURVE FOR PERFORMANCE STOCK UNITS (2008)



Source: The authors.

EXHIBIT 3 — VALEANT PHARMACEUTICALS: ACQUISITION HISTORY

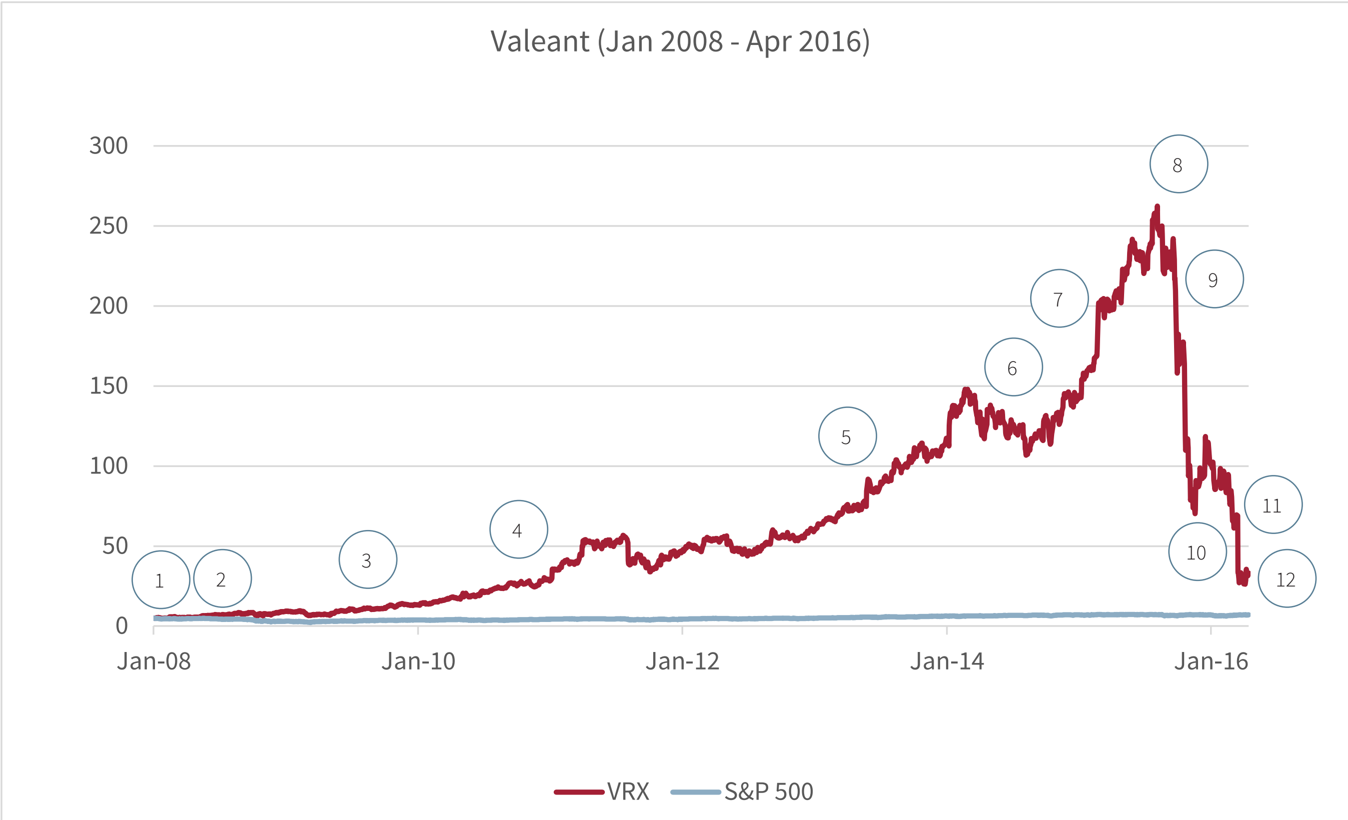
Year	Company	Value ($ in MM)
2015	Synergetics USA	$ 166
2015	Sprout Pharmceuticals	1,000
2015	Amoun Pharmaceutical	800
2015	Salix Pharmaceuticals	10,960
2015	Dendreon Corp (asset purchase)	296
2014	PreCision Dermatology	475
2014	Solta Medical	250
2013	Bausch & Lomb	8,700
2013	Obagi Medical Products	418
2013	Eisai (asset purchase)	65
2013	Natur Produkt International	163
2012	Medicis Pharmaceutical	2,600
2012	OraPharma	312
2012	Swiss Herbal (asset purchase)	n/a
2012	University Medical (asset purchase)	64
2012	Atlantis Pharma (asset purchase)	71

Year	Company	Value ($ in MM)
2012	Pedinol Pharmacal	n/a
2012	Gerot Lannach (asset purchase)	n/a
2012	Eyetech	n/a
2012	Probiotica Laboratories	67
2011	iNova	625
2011	Dermik	425
2011	Afexa Life Sciences	76
2011	AB Sanitas	440
2011	Ortho Dermatologics	345
2011	PharmaSwiss	490
2010	Biovail Corporation	3,300
2010	Aton Pharma	318
2010	Vital Science Corp	11
2010	Private company	56
2010	Private company	28

Note: Acquisition prices of foreign companies estimated based on prevailing currency rates.

Source: Valeant Pharmaceuticals press releases. Factiva.

EXHIBIT 4 — VALEANT PHARMACEUTICALS: STOCK PRICE HISTORY AND TIMELINE OF EVENTS

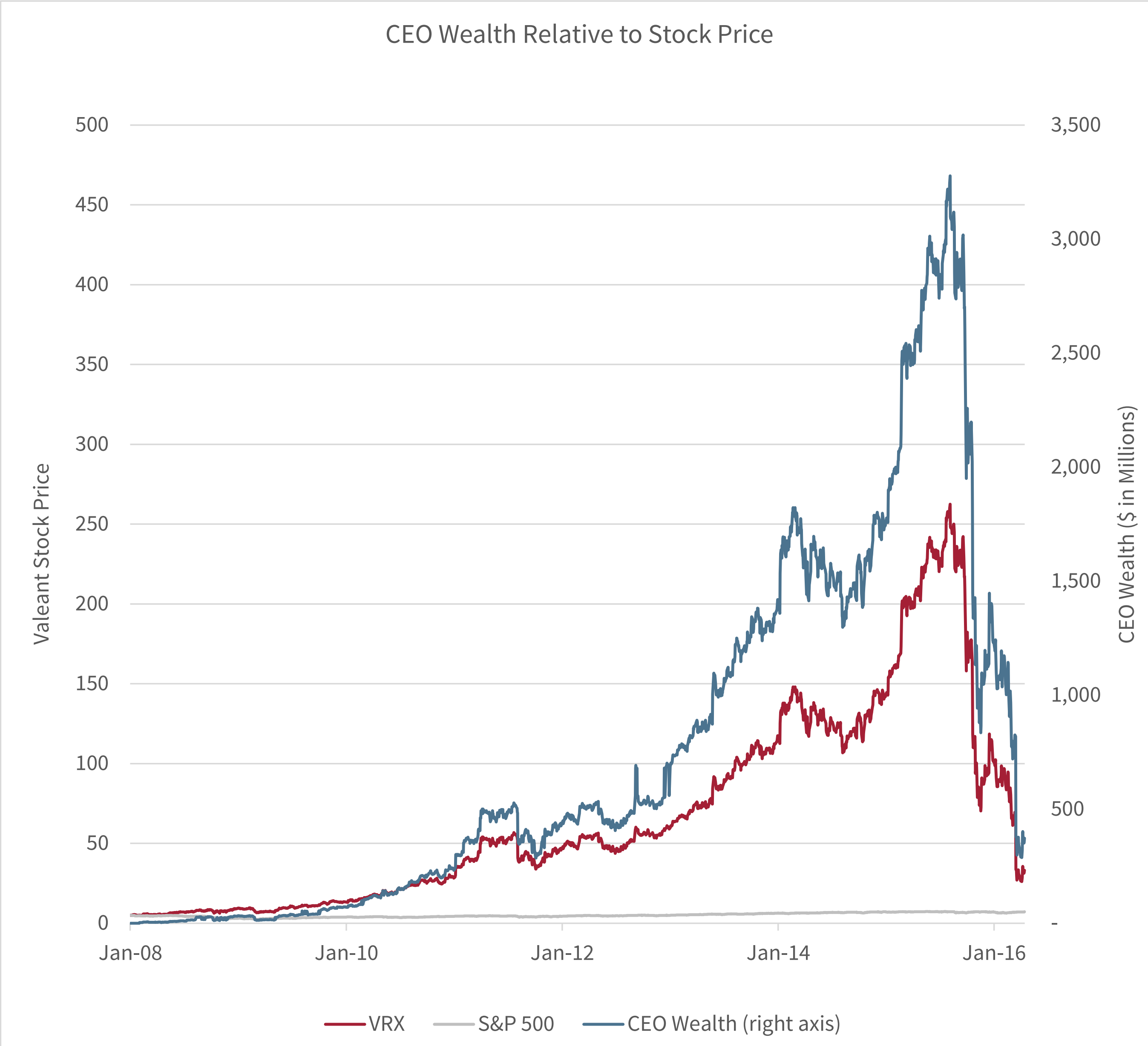


1. ValueAct acquires stake in Valeant (2006).
2. Pearson recruited as chairman and CEO; purchases shares and receives performance stock units.
3. Valeant renews Pearson's employment agreement; grants new performance units and extends holding requirements.
4. Valeant purchases Biovail in corporate tax inversion.
5. Valeant purchases Bausch + Lomb.
6. Valeant attempts hostile takeover of Allergan.
7. Valeant purchases Salix Pharmaceuticals.
8. Short-seller encourages scrutiny of Valeant's relation with specialty pharmacy Philidor.
9. U.S. Congress enquires about Valeant drug pricing.
10. Pearson goes on medical leave.
11. Valeant announces it will replace Pearson as CEO.
12. Valeant restates earnings, reduces guidance, and renegotiates covenants with lenders; Papa becomes CEO.

Note: Stock price adjusted for acquisition of Biovail (September 2010).

Source: Valeant Pharmaceuticals press releases. Factiva.

EXHIBIT 5 — VALEANT PHARMACEUTICALS: CHANGE IN CEO WEALTH



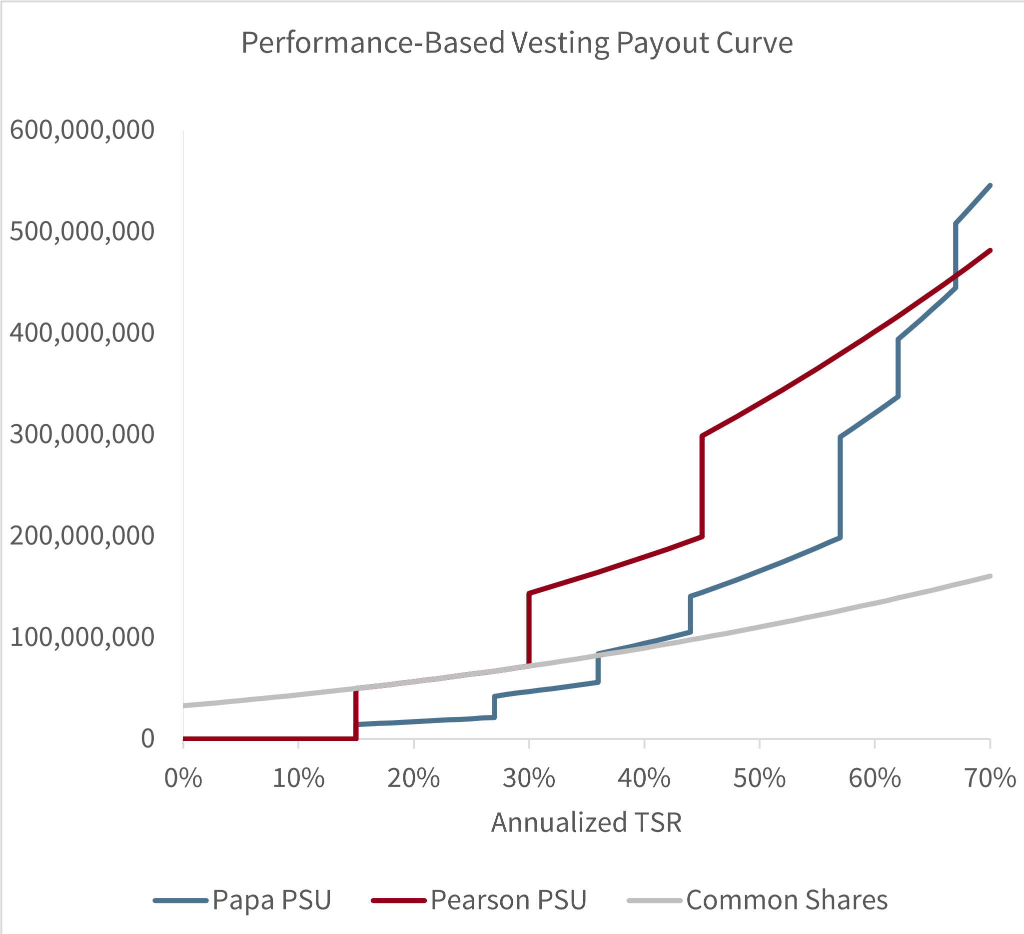
Source: Valeant Pharmaceuticals, Forms DEF-14A filed with the SEC. Calculations by the authors.

EXHIBIT 6 — VALEANT PHARMACEUTICALS: SELECTED FINANCIAL INFORMATION

$ in Millions (except per share data)	2008	2009	2010	2011	2012	2013	2014	2015 (9 mo.)
Revenue	$ 657.0	$ 830.5	$1,181.2	$2,463.5	$3,546.6	$5,769.6	$8,263.5	$7,710.1
Net Income (GAAP)	(196.1)	257.6	(208.2)	159.6	(116.0)	(866.1)	913.5	70.2
Net Income (Non-GAAP)	71.7	185.2	421.1	955.1	1,412.0	2,043.0	2,849.8	2,667.7
Operating Cash Flow (GAAP)	216.5	183.6	263.2	676.5	656.6	1,041.9	2,294.7	1,638.0
EPS (GAAP)	(2.24)	3.07	(1.06)	0.49	(0.38)	(2.70)	2.67	0.20
Cash EPS (Non-GAAP)	0.81	2.21	2.05	2.93	4.51	6.24	8.34	7.68
Total Assets	1,187.4	1,305.5	10,795.1	13,141.7	17,950.4	27,970.8	26,353.0	48,454.6
Goodwill and Intangibles	582.4	665.7	9,374.2	11,256.6	14,450.0	22,600.2	20,602.3	39,756.8
as a % of Total Assets	49%	51%	87%	86%	80%	81%	78%	82%
Debt	448.5	600.5	3,595.3	6,651.0	11,015.6	17,367.6	15,254.6	30,880.3
as a % of Total Assets	38%	46%	33%	51%	61%	62%	58%	64%
Research & Development	87.0	44.0	68.3	65.7	79.1	157.8	246.0	238.5
as a % of Revenue	13%	5%	6%	3%	2%	3%	3%	3%

Source: Valeant Pharmaceuticals, Forms 10-K and 10-Q filed with the SEC; earnings press releases.

EXHIBIT 7 — VALEANT PHARMACEUTICALS: PAYOUT CURVE FOR PERFORMANCE STOCK UNITS (2016)



Note: Papa received a target award of 933,416 performance share units subject to four-year vesting and the following hurdles: 0 shares awarded if the company's stock price in four years is below $60; 25 percent if the stock price exceeds $60; 50 percent if the stock price exceeds $90; 75 percent if it exceeds $120; 100 percent if it exceeds $150; 150 percent if it exceeds $210; 175 if it exceeds $240; and 200 percent if it exceeds $270. Pearson performance units restated for comparison purposes to reflect a target of 933,416 shares awarded at the share price and subject to the vesting conditions of his 2008 grant.

Source: The authors.