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Did the Federal Courts Just Legalize Channel Stuffing? One Big Pharma Lawyer Thinks So

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The federal appeals courts haven't explicitly legalized "channel-stuffing," an accounting trick that artificially inflates drug company revenues, but that appears to be the interpretation of **David Zornow**, the **Skadden Arps Slate Meagher & Flom** lawyer who won a recent ruling on behalf of two ex-**Bristol-Myers Squibb** (BMY) managers. He told Corporate Crime Reporter that even though BMS paid \$150 million to settle fraudulent accounting charges with the SEC, the company's accounting during the period described "real sales for real dollars ... this was a common practice in the pharmaceutical industry."

If that's so, then Big Pharma will likely see some historically amazing -- and completely fictitious -- revenue performances over the next 12 months as companies jam their warehouses with unsold products.

In the case, former BMS CFO **Frederick S. Schiff** and president **Richard Lane** were accused of ballooning the company's revenues by making payments to wholesalers if they bought drugs they did not need. BMS paid \$132 million to wholesales who then "bought" \$1.5 - \$2 billion of BMS drugs for which no customers existed.

Channel stuffing is, of course, a bit like a Ponzi scheme. Eventually, wholesalers run out of room for the

unsold product and decline to take more shipments until the stored lots are sold off. At that point, the drug company's revenues collapse like a soufflé. Pharmaceutical companies are tempted to engage in it because it helps executives "make their numbers" (and thus their bonuses) in the short term.

Schiff and Lane won deferred prosecution agreements from the ruling, which narrowed the grounds on which prosecutors can indict executives who don't tell the truth about their revenues. BMS's financial statement were technically compliant with Generally Accepted Accounting Rules, the ruling said, even though that may have been misleading when Schiff repeatedly told investors in 2001 he didn't see anything unusual in his wholesaler stocking trends. In 2002, the company suddenly said earnings per share would be down between 25 and 30 percent as wholesalers worked off their excess inventory.

Zornow told CCR:

The typical channel stuffing case is one where at the end of the quarter, I say to one of my customers "buy product from me so that I can ship it by the end of the quarter and make my numbers.

And I will take it back after the end of the quarter and give you a credit.

That's a transaction that was traditionally viewed as fraudulent because it had no economic substance.

One of the things that was different about this case and in our view made it a case that should have never been a criminal case is that these were real sales for real dollars.

This was a common practice in the pharmaceutical industry. There was no wink wink, nod nod understanding that the product was going to come back.

That's a scary statement for anyone investing in pharmaceutical stocks. It suggests that bribing wholesalers to buy product for which there is no demand is both common and legal, or at least not a crime. It also turns the current understanding of accounting rules -- that gross revenues should not be recognized if you cannot estimate future sales returns or, at net, if they may substantially reduce future revenues -- completely on its head.

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