

WATSON PHARMACEUTICALS INC

Form 10-Q

May 10, 2010

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**FORM 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2010**

**or**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission file number 001-13305**

**WATSON PHARMACEUTICALS, INC.**  
(Exact name of registrant as specified in its charter)

**Nevada**  
(State or other jurisdiction of  
incorporation or organization)

**95-3872914**  
(I.R.S. Employer Identification No.)

**311 Bonnie Circle  
Corona, CA 92880-2882**  
(Address of principal executive offices, including zip code)  
**(951) 493-5300**

(Registrant's telephone number, including area code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No   
Indicate by check mark whether the Registrant (1) has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting  
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

The number of shares outstanding of the Registrant's only class of common stock as of May 3, 2010 was approximately 124,566,000.



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**WATSON PHARMACEUTICALS, INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(Unaudited; in millions)

	<b>March 31, 2010</b>	<b>December 31, 2009</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 169.2	\$ 201.4
Marketable securities	13.1	13.6
Accounts receivable, net	543.8	519.5
Inventories, net	710.7	692.3
Prepaid expenses and other current assets	204.4	213.3
Deferred tax assets	128.5	130.9
<b>Total current assets</b>	<b>1,769.7</b>	<b>1,771.0</b>
Property and equipment, net	678.1	695.5
Investments and other assets	36.1	114.5
Deferred tax assets	50.9	41.2
Product rights and other intangibles, net	1,684.5	1,721.9
Goodwill	1,670.9	1,648.1
<b>Total assets</b>	<b>\$ 5,890.2</b>	<b>\$ 5,992.2</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable and accrued expenses	\$ 621.1	\$ 615.2
Income taxes payable	110.0	78.4
Short-term debt and current portion of long-term debt	85.0	307.6
Deferred revenue	24.9	16.3
Deferred tax liabilities	39.5	34.9
<b>Total current liabilities</b>	<b>880.5</b>	<b>1,052.4</b>
Long-term debt	1,155.5	1,150.2
Deferred revenue	28.1	31.9
Other long-term liabilities	119.2	118.7
Other taxes payable	71.4	61.7
Deferred tax liabilities	542.1	554.2
<b>Total liabilities</b>	<b>2,796.8</b>	<b>2,969.1</b>
Commitments and contingencies		
Stockholders' equity:		
Common stock	0.4	0.4
Additional paid-in capital	1,707.2	1,686.9
Retained earnings	1,709.9	1,640.1

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Accumulated other comprehensive (loss) income	(13.5)	1.9
Treasury stock, at cost	(310.6)	(306.2)
Total stockholders' equity	3,093.4	3,023.1
Total liabilities and stockholders' equity	\$ 5,890.2	\$ 5,992.2

*See accompanying Notes to Condensed Consolidated Financial Statements.*

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**WATSON PHARMACEUTICALS, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(Unaudited; in millions, except per share amounts)

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2010</b>	<b>2009</b>
Net revenues	\$ 856.5	\$ 667.4
Operating expenses:		
Cost of sales (excludes amortization, presented below)	504.7	388.7
Research and development	59.5	42.3
Selling and marketing	77.6	65.7
General and administrative	74.4	68.9
Amortization	39.0	21.8
Loss (gain) on asset sales and impairments	1.0	(1.5)
Total operating expenses	756.2	585.9
Operating income	100.3	81.5
Non-operating income (expense):		
Interest income	0.4	2.0
Interest expense	(20.3)	(4.7)
Other income	26.1	1.2
Total other income (expense), net	6.2	(1.5)
Income before income taxes and noncontrolling interest	106.5	80.0
Provision for income taxes	36.7	30.9
Income before noncontrolling interest	69.8	49.1
Income (loss) attributable to noncontrolling interest		
Net income attributable to common shareholders	\$ 69.8	\$ 49.1
Earnings per share:		
Basic	\$ 0.57	\$ 0.48
Diluted	\$ 0.57	\$ 0.43
Weighted average shares outstanding:		
Basic	121.7	103.1
Diluted	123.4	118.2

*See accompanying Notes to Condensed Consolidated Financial Statements.*

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**WATSON PHARMACEUTICALS, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Unaudited; in millions)

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2010</b>	<b>2009</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 69.8	\$ 49.1
Reconciliation to net cash provided by operating activities:		
Depreciation	24.7	23.2
Amortization	39.0	21.8
Deferred income tax (benefit) provision	(14.8)	5.7
Provision for inventory reserve	11.9	12.3
Restricted stock and stock option compensation	4.9	4.5
Earnings on equity method investments	(2.5)	(2.2)
(Gain) loss on securities	(23.4)	1.1
Gain on asset sales	0.1	(1.5)
Accretion of discount on preferred stock	6.6	
Other	(0.6)	(0.1)
Changes in assets and liabilities:		
Accounts receivable, net	(32.3)	(48.6)
Inventories	(44.1)	(15.3)
Prepaid expenses and other current assets	4.8	(0.8)
Accounts payable and accrued expenses	11.7	1.5
Deferred revenue	4.8	6.8
Income and other taxes payable	46.5	10.8
Other assets	5.2	1.2
Total adjustments	42.5	20.4
Net cash provided by operating activities	112.3	69.5
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Additions to property and equipment	(7.3)	(15.3)
Acquisition of product rights	(0.6)	(7.8)
Acquisition of business, net of cash acquired	(16.8)	
Proceeds from sale of fixed assets		3.0
Proceeds from sale of cost/equity investments	94.1	
Proceeds from sale of marketable securities	3.8	2.2
Additions to marketable securities	(2.8)	
Other	(2.0)	
Net cash provided by (used in) investing activities	68.4	(17.9)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		

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Principal payments on debt and other long-term liabilities	(3.4)	(1.6)
Principal payments on term loan, revolving loan and Lombard loan	(220.0)	
Repurchase of common stock	(4.4)	(2.2)
Proceeds from stock plans	14.9	3.6
Net cash used in financing activities	(212.9)	(0.2)
Net (decrease) increase in cash and cash equivalents	(32.2)	51.4
Cash and cash equivalents at beginning of period	201.4	507.6
Cash and cash equivalents at end of period	\$ 169.2	\$ 559.0

*See accompanying Notes to Condensed Consolidated Financial Statements.*

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Table of Contents**WATSON PHARMACEUTICALS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****NOTE 1 GENERAL**

Watson Pharmaceuticals, Inc. ( Watson or the Company ) is primarily engaged in the development, manufacturing, marketing, sale and distribution of brand and off-patent (generic) pharmaceutical products. Watson was incorporated in 1985 and began operations as a manufacturer and marketer of off-patent pharmaceuticals. Through internal product development and synergistic acquisitions of products and businesses, the Company has grown into a diversified specialty pharmaceutical company. Watson operates manufacturing, distribution, research and development ( R&D ) and administrative facilities in the United States of America ( U.S. ) and, beginning in 2009, in key international markets including Western Europe, Canada, Australasia, Asia, South America and South Africa.

The accompanying condensed consolidated financial statements should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2009. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with generally accepted accounting principles ( GAAP ) have been condensed or omitted from the accompanying condensed consolidated financial statements. The accompanying year end condensed consolidated balance sheet was derived from the audited financial statements. The accompanying interim financial statements are unaudited, but reflect all adjustments which are, in the opinion of management, necessary to present fairly Watson's consolidated financial position, results of operations and cash flows for the periods presented. Unless otherwise noted, all such adjustments are of a normal, recurring nature. The Company's results of operations and cash flows for the interim periods are not necessarily indicative of the results of operations and cash flows that it may achieve in future periods.

*Comprehensive Income*

Comprehensive income includes all changes in equity during a period except those that resulted from investments by or distributions to the Company's stockholders. Other comprehensive income refers to revenues, expenses, gains and losses that, under GAAP, are included in comprehensive income, but excluded from net income as these amounts are recorded directly as an adjustment to stockholders' equity. Watson's other comprehensive income (loss) is composed of unrealized gains (losses) on its holdings of publicly traded equity securities, net of realized gains (losses) included in net income and foreign currency translation adjustments. The components of comprehensive income including attributable income taxes consisted of the following (in millions):

	<b>Three Months Ended March 31,</b>	
	<b>2010</b>	<b>2009</b>
Net income	\$ 69.8	\$ 49.1
Other comprehensive loss:		
Translation losses	(15.8)	(1.3)
Unrealized gains (losses) on securities, net of tax	0.4	(0.2)
Reclassification for losses included in net income, net of tax		1.4
Total other comprehensive loss	(15.4)	(0.1)
Total comprehensive income	\$ 54.4	\$ 49.0

**Table of Contents***Preferred and Common Stock*

As of March 31, 2010 and December 31, 2009 there were 2.5 million shares of no par value per share preferred stock authorized. The Board has the authority to fix the rights, preferences, privileges and restrictions, including but not limited to, dividend rates, conversion and voting rights, terms and prices of redemptions and liquidation preferences without vote or action by the stockholders. On December 2, 2009 the Company issued 200,000 shares of Mandatorily Redeemable Preferred Stock. The Mandatorily Redeemable Preferred Stock is redeemable in cash on December 2, 2012, and is accordingly included within long-term debt in the consolidated balance sheet at March 31, 2010 and December 31, 2009. See Note 7 DEBT for additional discussion. As of March 31, 2010 and December 31, 2009, there were 500.0 million shares of \$0.0033 par value per share common stock authorized, with 134.2 million and 133.0 million shares issued and 124.5 million and 123.4 million outstanding, respectively. Of the issued shares, 9.7 million shares and 9.6 million shares were held as treasury shares as of March 31, 2010 and December 31, 2009, respectively.

*Revenue Recognition*

Revenue is generally realized or realizable and earned when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the seller's price to the buyer is fixed or determinable, and collectability is reasonably assured. The Company records revenue from product sales when title and risk of ownership have been transferred to the customer, which is typically upon delivery to the customer. Revenues recognized from research, development and licensing agreements (including milestone payments) are recorded on the contingency-adjusted performance model which requires deferral of revenue until such time as contract milestone requirements, as specified in the individual agreements, have been met. Under this model, revenue related to each payment is recognized over the entire contract performance period, starting with the contract's commencement, but not prior to earning and/or receiving the milestone payment (i.e. removal of any contingency). The amount of revenue recognized is based on the ratio of costs incurred to date to total estimated cost to be incurred. Royalty and commission revenue is recognized in accordance with the terms of their respective contractual agreements when collectability is reasonably assured and revenue can be reasonably measured.

*Revenue and Provision for Sales Returns and Allowances*

As customary in the pharmaceutical industry, the Company's gross product sales are subject to a variety of deductions in arriving at reported net product sales. When the Company recognizes revenue from the sale of products, an estimate of sales returns and allowances (SRA) is recorded which reduces product sales. Accounts receivable and/or accrued liabilities are also reduced and/or increased by the SRA amount. These adjustments include estimates for chargebacks, rebates, cash discounts and returns and other allowances. These provisions are estimated based on historical payment experience, historical relationship to revenues, estimated customer inventory levels and current contract sales terms with direct and indirect customers. The estimation process used to determine our SRA provision has been applied on a consistent basis and no material adjustments have been necessary to increase or decrease our reserves for SRA as a result of a significant change in underlying estimates. The Company uses a variety of methods to assess the adequacy of our SRA reserves to ensure that our financial statements are fairly stated. This includes periodic reviews of customer inventory data, customer contract programs and product pricing trends to analyze and validate the SRA reserves.

The provision for chargebacks is our most significant sales allowance. A chargeback represents an amount payable in the future to a wholesaler for the difference between the invoice price paid to the Company by our wholesale customer for a particular product and the negotiated contract price that the wholesaler's customer pays for that product. The Company's chargeback provision and related reserve varies with changes in product mix, changes in customer pricing and changes to estimated wholesaler inventories. The provision for chargebacks also takes into account an estimate of the expected wholesaler sell-through levels to indirect customers at contract prices. The Company validates the chargeback accrual quarterly through a review of the inventory reports obtained from our largest wholesale customers. This customer inventory information is used to verify the estimated liability for future chargeback claims based on historical chargeback and contract rates. These large

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wholesalers represent 85% - 90% of the Company's chargeback payments. The Company continually monitors current pricing trends and wholesaler inventory levels to ensure the liability for future chargebacks is fairly stated.

Net revenues and accounts receivable balances in the Company's condensed consolidated financial statements are presented net of SRA estimates. Certain SRA balances are included in accounts payable and accrued liabilities. Accounts receivable are presented net of SRA balances of \$310.3 million and \$332.9 million at March 31, 2010 and December 31, 2009, respectively. Accounts payable and accrued liabilities include \$89.0 million and \$83.6 million at March 31, 2010 and December 31, 2009, respectively, for certain rebates and other amounts due to indirect customers.

**Earnings Per Share (EPS)**

Basic EPS is computed by dividing net income by the weighted average common shares outstanding during a period. Diluted EPS is based on the treasury stock method and includes the effect from potential issuance of common stock, such as shares issuable upon conversion of our convertible contingent senior debentures (CODES), and shares issuable pursuant to the exercise of stock options, assuming the exercise of all in-the-money stock options. Common share equivalents have been excluded where their inclusion would be anti-dilutive. The Company is required to add the weighted average potential common shares outstanding associated with the conversion of the CODES to the number of shares outstanding for the calculation of diluted EPS for all periods in which the securities were outstanding. On September 14, 2009 the CODES were redeemed in accordance with the terms of the CODES. A reconciliation of the numerators and denominators of basic and diluted EPS consisted of the following (in millions, except per share amounts):

	<b>Three months ended March 31,</b>	
	<b>2010</b>	<b>2009</b>
<b>EPS - basic</b>		
Net income	\$ 69.8	\$ 49.1
Basic weighted average common shares outstanding	121.7	103.1
EPS - basic	\$ 0.57	\$ 0.48
<b>EPS - diluted</b>		
Net income	\$ 69.8	\$ 49.1
Add: Interest expense on CODES, net of tax		1.9
Net income, adjusted	\$ 69.8	\$ 51.0
Basic weighted average common shares outstanding	121.7	103.1
Effect of dilutive securities:		
Conversion of CODES		14.4
Dilutive stock awards	1.7	0.7
Diluted weighted average common shares outstanding	123.4	118.2
EPS - diluted	\$ 0.57	\$ 0.43

Stock awards to purchase 1.5 million and 6.0 million common shares for the three month periods ended March 31, 2010 and 2009, respectively, were outstanding but were not included in the computation of diluted earnings per share because the options were anti-dilutive.

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*Share-Based Compensation*

The Company recognizes compensation expense for all share-based compensation awards made to employees and directors based on estimated fair values. Share-based compensation expense recognized during a period is based on the value of the portion of share-based awards that are expected to vest with employees. Accordingly, the recognition of share-based compensation expense has been reduced for estimated future forfeitures. These estimates will be revised in future periods if actual forfeitures differ from the estimates. Changes in forfeiture estimates impact compensation expense in the period in which the change in estimate occurs.

As of March 31, 2010, the Company had \$1.1 million of total unrecognized compensation expense, net of estimated forfeitures, related to stock option grants, which will be recognized over the remaining weighted average period of 1.1 years. As of March 31, 2010, the Company had \$36.9 million of total unrecognized compensation expense, net of estimated forfeitures, related to restricted stock grants, which will be recognized over the remaining weighted average period of 2.1 years. During the three months ended March 31, 2010, the Company issued approximately 793,000 restricted stock grants with an aggregate intrinsic value of \$31.8 million. No stock option grants were issued during the three months ended March 31, 2010.

*Recent Accounting Pronouncements*

In June 2009, the Financial Accounting Standards Board ( FASB ) issued an amendment to the accounting and disclosure requirements for the consolidation of variable interest entities ( VIEs ). The amendment eliminates the quantitative approach previously required for determining the primary beneficiary of a VIE and requires an enterprise to perform a qualitative analysis when determining whether or not to consolidate a VIE. The amendment requires an enterprise to continuously reassess whether it must consolidate a VIE and also requires enhanced disclosures about an enterprise's involvement with a VIE and any significant change in risk exposure due to that involvement, as well as how its involvement with a VIE impacts the enterprise's financial statements. This amendment is effective for fiscal years beginning after November 15, 2009. The adoption of the provisions of the guidance did not have a material impact on the Company's consolidated financial statements.

In October 2009, the FASB issued an amendment to its accounting guidance on revenue arrangements with multiple deliverables, which addresses the unit of accounting for arrangements involving multiple deliverables and how consideration should be allocated to separate units of accounting, when applicable. The amendment requires that arrangement considerations be allocated at the inception of the arrangement to all deliverables using the relative selling price method and provides for expanded disclosures related to such arrangements. The amendment is effective for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Early adoption is allowed. We are currently evaluating the impact of the adoption of this amendment on the Company's consolidated financial statements.

In March 2010, the FASB ratified accounting guidance on defining a milestone and determining when it may be appropriate to apply the milestone method of revenue recognition for research or development transactions. This guidance provides criteria that must be met to recognize consideration that is contingent upon achievement of a substantive milestone in its entirety in the period in which the milestone is achieved. The amendment is effective for milestones achieved in fiscal years beginning on or after June 15, 2010. Early adoption is allowed. We are currently evaluating the impact of the adoption of this amendment on the Company's consolidated financial statements.

**Table of Contents****NOTE 2 OTHER INCOME**

Other income consisted of the following (in millions):

	<b>Three Months Ended March</b>	
	<b>2010</b>	<b>2009</b>
Earnings on equity method investments	\$ 2.5	\$ 2.2
Gain (loss) on securities	23.4	(1.1)
Other income	0.2	0.1
	<b>\$ 26.1</b>	<b>\$ 1.2</b>

For additional information on the gain on securities for the three months ended March 31, 2010, refer to NOTE 3 ACQUISITIONS AND DIVESTITURES below.

**NOTE 3 ACQUISITIONS AND DIVESTITURES***Acquisition of Arrow Group*

On December 2, 2009 (the Acquisition Date), Watson completed its acquisition of all the outstanding equity of Robin Hood Holdings Limited, a Malta private limited liability company, and Cobalt Laboratories, Inc., a Delaware corporation (together the Arrow Group) for cash, stock and other certain contingent consideration (the Arrow Acquisition). The Arrow Group is engaged in the manufacture and distribution of generic pharmaceuticals and operates principally in the U.S. and international markets including Western Europe, Canada, Australasia, Asia, South America and South Africa.

As a result of the Arrow Acquisition, Watson also acquired a 36% ownership interest in Eden Biopharm Group Limited (Eden), a company which provides development and manufacturing services for early-stage biotech companies. In January 2010 Watson purchased the remaining interest in Eden for \$15.0 million. Eden results will be included within our Global Brand segment. For additional information on the Arrow Acquisition, refer to ITEM 1 BUSINESS and NOTE 4 Arrow Acquisition in our Annual Report on Form 10-K for the year ended December 31, 2009.

For reporting purposes, Arrow Group results are included in our Global Generic segment except for Eden results which are included in our Global Brand segment.

*Sale of Scinopharm Taiwan Ltd. (Scinopharm)*

On March 24, 2010, all closing conditions were satisfied in our agreement with Uni-President Enterprises Corporation to sell our outstanding shares of Scinopharm. Under the terms of the stock purchase agreement, we sold our entire holdings of common shares for net proceeds of approximately \$94.0 million resulting in a gain on sale of securities in the amount of \$23.4 million for the three months ended March 31, 2010.

**NOTE 4 REPORTABLE SEGMENTS**

Watson has three reportable operating segments: Global Generic, Global Brand and Distribution. The Global Generic segment includes off-patent pharmaceutical products that are therapeutically equivalent to proprietary products. The Global Brand segment includes patent-protected products and certain trademarked off-patent products that Watson sells and markets as brand pharmaceutical products. The Distribution segment mainly distributes generic pharmaceutical products manufactured by third parties, as well as by Watson, primarily to independent pharmacies, pharmacy chains, pharmacy buying groups and physicians' offices under the Anda trade name. Sales are principally generated through a combination of national sales representatives, an in-house telemarketing staff and through internally developed



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ordering systems. The Distribution segment operating results exclude sales by Anda of products developed, acquired, or licensed by Watson's Global Generic and Global Brand segments. Arrow results are included in the Global Generic segment subsequent to the date of acquisition except for operating results from Eden which are included in our Global Brand segment.

The other classification consists primarily of commission revenue, royalties and revenues from research, development and licensing fees and also includes co-promotion revenue and revenue (including the amortization of deferred revenue) relating to our obligation to manufacture and supply products to third parties. The Company evaluates segment performance based on segment contribution. Segment contribution represents segment net revenues less cost of sales (excludes amortization), direct R&D expenses and selling and marketing expenses. The Company does not report total assets, capital expenditures, corporate general and administrative expenses, amortization, gains on disposal or impairment losses by segment as such information has not been used by management, or has not been accounted for at the segment level.

Segment net revenues, segment operating expenses and segment contribution information for the Company's Global Generic, Global Brand and Distribution segments consisted of the following (in millions):

	Three Months Ended March 31, 2010				Three Months Ended March 31, 2009			
	Generic	Brand	Distribution	Total	Generic	Brand	Distribution	Total
Product sales	\$ 534.1	\$ 72.4	\$ 221.4	\$ 827.9	\$ 395.2	\$ 98.2	\$ 153.7	\$ 647.1
Other	9.7	18.9		28.6	6.5	13.8		20.3
Net revenues	543.8	91.3	221.4	856.5	401.7	112.0	153.7	667.4
Cost of sales <sup>(1)</sup>	287.5	24.7	192.5	504.7	238.5	24.2	126.0	388.7
Gross profit <sup>(1)</sup>	256.3	66.6	28.9	351.8	163.2	87.8	27.7	278.7
Gross margin <sup>(1)</sup>	47.1%	72.9%	13.1%	41.1%	40.6%	78.4%	18.0%	41.8%
Research and development	42.2	17.3		59.5	30.1	12.2		42.3
Selling and marketing	26.9	32.5	18.2	77.6	12.7	36.9	16.1	65.7
Contribution	\$ 187.2	\$ 16.8	\$ 10.7	214.7	\$ 120.4	\$ 38.7	\$ 11.6	170.7
Contribution margin	34.4%	18.4%	4.8%	25.1%	30.0%	34.6%	7.5%	25.6%
General and administrative				74.4				68.9
Amortization				39.0				21.8
Gain on asset sales				1.0				(1.5)
Operating income				\$ 100.3				\$ 81.5
Operating margin				11.7%				12.2%

(1) Excludes amortization of acquired intangibles including

product rights.

**NOTE 5 INVENTORIES**

Inventories consist of finished goods held for sale and distribution, raw materials and work-in-process. Included in inventory at March 31, 2010 and December 31, 2009 is approximately \$4.2 million and \$14.1 million, respectively, of inventory that is pending approval by the U.S. Food and Drug Administration ( FDA ), by other regulatory agencies or has not been launched due to contractual restrictions. This inventory consists primarily of generic pharmaceutical products that are capitalized only when the bioequivalence of the product is demonstrated or the product is already FDA approved and is awaiting a contractual triggering event to enter the marketplace.

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Inventories are stated at the lower of cost (first-in, first-out method) or market (net realizable value) and consisted of the following (in millions):

	<b>March 31, 2010</b>	<b>December 31, 2009</b>
<b>Inventories:</b>		
Raw materials	\$ 175.4	\$ 194.5
Work-in-process	42.3	44.1
Finished goods	493.0	453.7
Inventories, net	\$ 710.7	\$ 692.3

**NOTE 6 GOODWILL**

Goodwill for the Company's reporting units consisted of the following (in millions):

	<b>March 31, 2010</b>	<b>December 31, 2009</b>
Global Brand segment	\$ 371.6	\$ 348.2
Global Generic segment	1,213.0	1,213.6
Distribution segment	86.3	86.3
Total goodwill	\$ 1,670.9	\$ 1,648.1

The increase in goodwill for the three months ended March 31, 2010 primarily relates to the acquisition of the remaining 64% of Eden as discussed in NOTE 3 ACQUISITIONS AND DIVESTITURES.

**NOTE 7 DEBT**

Debt consisted of the following (in millions):

	<b>March 31, 2010</b>	<b>December 31, 2009</b>
Senior Notes, \$450.0 million 5.000% notes due August 14, 2014 (the 2014 Notes )	\$ 450.0	\$ 450.0
\$400.0 million 6.125% notes due August 14, 2019 (the 2019 Notes ) together the Senior Notes	400.0	400.0
	850.0	850.0
Less: Unamortized discount	(2.4)	(2.5)
Senior Notes, net	847.6	847.5
Senior Credit Facility with Canadian Imperial Bank of Commerce, Wachovia Capital Markets, LLC and a syndicate of banks ( 2006 Credit Facility ), due 2011	200.0	400.0
Mandatorily Redeemable Preferred Stock	154.9	151.2
Loan with Lombard Odier Darier Hentsch & Cie ( Lombard Loan )	35.0	55.0
Other notes payable	3.0	4.1
	1,240.5	1,457.8

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Less: Current portion	85.0	307.6
Total long-term debt	\$ 1,155.5	\$ 1,150.2

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***Senior Notes***

The offering of \$450.0 million of 2014 Notes and \$400.0 million of 2019 Notes was registered under an automatic shelf registration statement filed with the Securities and Exchange Commission ( SEC ). The Senior Notes were issued pursuant to a senior note indenture dated as of August 24, 2009 between the Company and Wells Fargo Bank, National Association, as trustee, as supplemented by a first supplemental indenture dated August 24, 2009 and a second supplemental indenture dated May 7, 2010 (together the Senior Note Indentures ).

Interest payments are due on the Senior Notes semi-annually in arrears on February 15 and August 15 respectively, beginning February 15, 2010 at an effective annual interest rate of 5.43% on the 2014 Notes and 6.35% on the 2019 Notes.

***2006 Credit Facility***

In November 2006, the Company entered into the 2006 Credit Facility with Canadian Imperial Bank of Commerce, acting through its New York agency, as Administrative Agent, Wachovia Capital Markets, LLC, as Syndication Agent, and a syndicate of banks. The 2006 Credit Facility provides an aggregate of \$1.15 billion of senior financing to Watson, consisting of a \$500.0 million revolving credit facility ( Revolving Facility ) and a \$650.0 million senior term loan facility ( Term Facility ). The 2006 Credit Facility has a five-year term and bears interest equal to LIBOR plus 0.75% (subject to certain adjustments).

The Company made a \$200.0 million repayment on the Revolving Facility of the 2006 Credit Facility in the three months ended March 31, 2010. As of March 31, 2010, \$50.0 million was outstanding on the Revolving Facility and \$150.0 million was outstanding on the Term Facility. There are no scheduled debt payments required in 2010 and the full amount outstanding on the 2009 Credit Facility is due November 2011.

***Mandatorily Redeemable Preferred Stock***

In connection with the Arrow Acquisition, Watson issued 200,000 shares of newly designed non-voting Series A Preferred Stock of Watson having a stated value of \$1,000 per share, or an aggregate stated value of \$200.0 million, which have been placed in an indemnity escrow account for a period of three years.

In accordance with existing U.S. GAAP, the Mandatorily Redeemable Preferred Stock has been reported as long-term debt and accretion expense has been classified as interest expense. The fair value of the Mandatorily Redeemable Preferred Stock was estimated to be \$150.0 million at December 2, 2009 based on the mandatory redemption value of \$200.0 million on December 2, 2012 using a discount rate of 9.63% per annum. At March 31, 2010, the unamortized accretion expense for the Preferred Stock was \$45.1 million.

***Lombard Loan***

On November 25, 2009, prior to closing the Arrow Acquisition, the Arrow Group received loan proceeds on the Lombard Loan in the amount of \$90.0 million. The Lombard Loan is mandatorily repayable from anticipated net proceeds from amounts due from Sepracor, Inc. (the Sepracor Receivable ). The Lombard Loan is guaranteed by one or more of the Arrow Selling Shareholders (the Guarantor ). In the event Sepracor fails to make anticipated royalty/milestone payments to Watson on the Sepracor Receivable for any reason, the Guarantor must repay the outstanding portion of the Lombard Loan or reimburse Arrow Group for such defaulted amount.

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In accordance with the terms of the Lombard Loan, the Company repaid \$35.0 million in December 2009 and \$20.0 million in March 2010. At March 31, 2010, a \$35.0 million advance bearing interest at a rate of 1.99% per annum was outstanding which matures on December 31, 2010.

**Fair Value of Debt Instruments**

Based on quoted market rates of interest and maturity schedules for similar debt issues, we estimate that the fair values of our 2006 Credit Facility and our other notes payable approximated their carrying values on March 31, 2010. As of March 31, 2010, the fair value of our Senior Notes was \$44.7 million greater than the carrying value. While changes in market interest rates may affect the fair value of our fixed-rate debt, we believe the effect, if any, of reasonably possible near-term changes in the fair value of such debt on our financial condition, results of operations or cash flows will not be material.

**NOTE 8 BUSINESS RESTRUCTURING CHARGES**

During the first quarter of 2008, the Company announced efforts to reduce its cost structure with the planned closure of its manufacturing facilities in Carmel, New York and its distribution center in Brewster, New York. Activity related to our business restructuring and facility rationalization activities for the three months ended March 31, 2010 consisted of the following (in millions):

	<b>Balance at December 31, 2009</b>	<b>Charged to Expense</b>	<b>Cash Payments</b>	<b>Non-cash Adjustments</b>	<b>Balance at March 31, 2010</b>
Cost of sales					
Severance and retention	\$ 13.1	\$ 1.1	\$ (2.0)	\$	\$ 12.2
Product transfer costs	1.0	0.3	(0.8)		0.5
Facility decommission costs	0.2	2.2	(1.4)		1.0
Accelerated depreciation		1.4		(1.4)	
	14.3	5.0	(4.2)	(1.4)	13.7
Operating expenses					
Research and development	0.8		(0.4)		0.4
Selling, general and administrative	0.8	0.2	(0.4)		0.6
	1.6	0.2	(0.8)		1.0
Total restructuring charges	\$ 15.9	\$ 5.2	\$ (5.0)	\$ (1.4)	\$ 14.7

Product transfer costs consist of documentation, testing and shipping costs to transfer product to other facilities. Operating expenses include severance and retention. Retention is expensed only to the extent earned by employees. Activity related to our business restructuring and facility rationalization activities is primarily attributable to our Global Generic segment.

**NOTE 9 INCOME TAXES**

The Company's effective tax rate for the three months ended March 31, 2010 was 34.5% compared to 38.6% for the three months ended March 31, 2009. The lower effective tax rate for the three months ended March 31, 2010, as compared to the same period of the prior year, is primarily due to tax benefits from the sale of our Sweden subsidiary.

The Company conducts business globally and, as a result, it files federal, state and foreign tax returns. The Company strives to resolve open matters with each tax authority at the examination level and could reach agreement with a tax authority at any time. While the Company has accrued for amounts it believes are the probable outcomes,

the final outcome with a tax authority may result in a tax liability that is more or less than that reflected in the condensed consolidated financial statements. Furthermore, the Company may later decide to challenge any assessments, if made, and may exercise its right to appeal. The uncertain tax

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positions are reviewed quarterly and adjusted as events occur that affect potential liabilities for additional taxes, such as lapsing of applicable statutes of limitations, proposed assessments by tax authorities, negotiations between tax authorities, identification of new issues and issuance of new legislation, regulations or case law. Management believes that adequate amounts of tax and related penalty and interest have been provided for any adjustments that may result from these uncertain tax positions.

With few exceptions, the Company is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations for years before 2000. In 2008, the Internal Revenue Service ( IRS ) began examining the Company's 2004-2006 tax years. The IRS has indicated that it is their intention to finish their examination of those years in 2010. While it is often difficult to predict the final outcome or the timing of resolution of any particular uncertain tax position, the Company has accrued for amounts it believes are the likely outcomes.

**NOTE 10 STOCKHOLDERS EQUITY**

A summary of the changes in stockholders' equity for the three months ended March 31, 2010 consisted of the following (in millions):

Stockholders' equity, December 31, 2009	\$ 3,023.1
Common stock issued under employee plans	14.9
Increase in additional paid-in capital for share-based compensation plans	4.9
Net income	69.8
Other comprehensive loss	(15.4)
Tax benefit from employee stock plans	0.5
Repurchase of common stock	(4.4)
Stockholders' equity, March 31, 2010	\$ 3,093.4

**NOTE 11 FAIR VALUE MEASUREMENT**

In September 2006, the FASB issued authoritative guidance for fair value measurements, which defines fair value, establishes a framework for measuring fair value in GAAP and expands disclosures about fair value measurements. The Company adopted the provisions of the guidance effective January 1, 2008 for all financial assets and liabilities and any other assets and liabilities that are recognized or disclosed at fair value on a recurring basis. The Company adopted the provisions of the guidance for nonfinancial assets and liabilities measured at fair value on a non-recurring basis effective January 1, 2009. Although the adoption of the guidance did not materially impact the Company's financial condition, results of operations or cash flows, we are required to provide additional disclosures within our condensed consolidated financial statements.

The guidance defines fair value as the price that would be received to sell an asset or paid to transfer the liability (an exit price) in an orderly transaction between market participants and also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The fair value hierarchy within the guidance distinguishes three levels of inputs that may be utilized when measuring fair value, including level 1 inputs (using quoted prices in active markets for identical assets or liabilities), level 2 inputs (using inputs other than level 1 prices such as quoted prices for similar assets and liabilities in active markets or inputs that are observable for the asset or liability) and level 3 inputs (using unobservable inputs supported by little or no market activity based on our own assumptions used to measure assets and liabilities). A financial asset or liability's classification within the above hierarchy is determined based on the lowest level input that is significant to the fair value measurement.



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Financial assets and liabilities measured at fair value or disclosed at fair value on a recurring basis as at March 31, 2010 and December 31, 2009 consisted of the following (in millions):

	<b>Fair Value Measurements as at March 31, 2010 Using:</b>			
	<b>Total</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
<b>Assets:</b>				
Marketable securities	\$ 13.1	\$ 13.1	\$	\$
Investments	3.0	3.0		
<b>Liabilities:</b>				
Contingent consideration	113.9			113.9

	<b>Fair Value Measurements as at December 31, 2009 Using:</b>			
	<b>Total</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
<b>Assets:</b>				
Marketable securities	\$ 13.6	\$ 13.6	\$	\$
Investments	3.0	3.0		
<b>Liabilities:</b>				
Contingent consideration	111.0			111.0

Marketable securities and investments consist of available-for-sale investments in U.S. Treasury and agency securities and publicly traded equity securities for which market prices are readily available. Unrealized gains or losses on marketable securities and investments are recorded in accumulated other comprehensive income (loss).

The fair value measurement of the contingent consideration obligation to the Arrow Selling Shareholders is determined using Level 3 inputs. The fair value of the contingent consideration obligation is based on a probability-weighted income approach. The measurement is based upon unobservable inputs supported by little or no market activity based on our own assumptions. Changes in the value of the contingent consideration obligation is recorded as a component of operating income in our consolidated statement of operations. For the three months ended March 31, 2010, \$2.9 million has been included within interest expense in the accompanying condensed consolidated statement of operations.

**NOTE 12 CONTINGENCIES****Legal Matters**

Watson and its affiliates are involved in various disputes, governmental and/or regulatory inspections, inquiries, investigations and proceedings, and litigation matters that arise from time to time in the ordinary course of business. The process of resolving matters through litigation or other means is inherently uncertain and it is possible that an unfavorable resolution of these matters will adversely affect the Company, its results of operations, financial condition and cash flows. The Company's regular practice is to expense legal fees as services are rendered in connection with legal matters, and to accrue for liabilities when losses are probable and reasonably estimable.

*Cipro® Litigation.* Beginning in July 2000, a number of suits were filed against Watson, The Rugby Group, Inc. ( Rugby ) and other company affiliates in various state and federal courts alleging claims under various federal and state competition and consumer protection laws. Several plaintiffs have filed amended complaints and motions seeking class certification. Approximately 42 cases had been filed against Watson, Rugby and other Watson entities. Twenty-two of these actions have been consolidated in the U.S. District Court for the Eastern District of New York ( *In re: Ciprofloxacin Hydrochloride Antitrust Litigation, MDL Docket No. 001383* ). On May 20, 2003, the court hearing the consolidated action granted Watson's motion to dismiss and made rulings

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limiting the theories under which plaintiffs can seek recovery against Rugby and the other defendants. On March 31, 2005, the court hearing the consolidated action granted summary judgment in favor of the defendants on all of plaintiffs' claims, denied the plaintiffs' motions for class certification, and directed the clerk of the court to close the case. On May 7, 2005, three groups of plaintiffs from the consolidated action (the direct purchaser plaintiffs, the indirect purchaser plaintiffs and plaintiffs Rite Aid and CVS) filed notices of appeal in the United States Court of Appeals for the Second Circuit, appealing, among other things, the May 20, 2003 order dismissing Watson and the March 31, 2005 order granting summary judgment in favor of the defendants. The three appeals were consolidated by the appellate court. On August 25, 2005, the defendants moved to transfer the appeals to the United States Court of Appeals for the Federal Circuit on the ground that patent issues are involved in the appeal. On November 7, 2007, the motions panel of the U.S. Court of Appeals for the Second Circuit granted the motion in part, and ordered the appeal by the indirect purchaser plaintiffs transferred to the United States Court of Appeals for the Federal Circuit. On October 15, 2008, the United States Court of Appeals for the Federal Circuit affirmed the dismissal of the indirect purchasers' claims, and on December 22, 2008, denied the indirect purchaser plaintiffs' petition for rehearing and rehearing en banc. On March 23, 2009, the indirect purchaser plaintiffs filed a petition for writ of certiorari with the United States Supreme Court. On June 22, 2009, the Supreme Court denied the petition. In the appeal in the United States Court of Appeals for the Second Circuit by the direct purchaser plaintiffs and plaintiffs CVS and Riteaid, the Second Circuit heard oral argument by the parties on April 28, 2009, and advised the parties that the court had invited the United States Department of Justice to provide comments on the case. On July 6, 2009, the Department of Justice submitted a brief on the matter, expressing no opinion on the Cipro action but suggesting certain standards to evaluate reverse payment patent settlements. On August 12, 2009, the parties responded to the Department of Justice's brief. On April 29, 2010, the United States Court of Appeals for the Second Circuit affirmed the ruling of the District Court granting summary judgment in favor of the defendants. The appellants have until May 13, 2010 to petition the Second Circuit for reconsideration or rehearing en banc. Other actions are pending in various state courts, including New York, California, Kansas, Tennessee, and Florida. The actions generally allege that the defendants engaged in unlawful, anticompetitive conduct in connection with alleged agreements, entered into prior to Watson's acquisition of Rugby from Sanofi Aventis (Aventis), related to the development, manufacture and sale of the drug substance ciprofloxacin hydrochloride, the generic version of Bayer's brand drug, Cipro®. The actions generally seek declaratory judgment, damages, injunctive relief, restitution and other relief on behalf of certain purported classes of individuals and other entities. The court hearing the case in New York has dismissed the action. Appellants have sought leave to appeal the dismissal of the New York action to the New York Court of Appeals. On April 18, 2006, the New York Supreme Court, Appellate Division, denied the appellants' motion. In the action pending in Kansas, the court has administratively terminated the matter pending the outcome of the appeals in the consolidated case. In the action pending in the California Superior Court for the County of San Diego (*In re: Cipro Cases I & II, JCCP Proceeding Nos. 4154 & 4220*), on July 21, 2004, the California Court of Appeal granted in part and denied in part the defendants' petition for a writ of mandate seeking to reverse the trial court's order granting the plaintiffs' motion for class certification. Pursuant to the appellate court's ruling, the majority of the plaintiffs will be permitted to pursue their claims as a class. On August 31, 2009, the California Superior Court granted defendants' motion for summary judgment, and final judgment was entered on September 24, 2009. On November 19, 2009, the plaintiffs filed a notice of appeal. The appeal is being briefed by the parties. In addition to the pending actions, Watson understands that various state and federal agencies are investigating the allegations made in these actions. Aventis has agreed to defend and indemnify Watson and its affiliates in connection with the claims and investigations arising from the conduct and agreements allegedly undertaken by Rugby and its affiliates prior to Watson's acquisition of Rugby, and is currently controlling the defense of these actions.

*Governmental Reimbursement Investigations and Drug Pricing Litigation.* In November 1999, Schein Pharmaceutical, Inc., now known as Watson Pharma, Inc. (Watson Pharma) was informed by the U.S. Department of Justice that Watson Pharma, along with numerous other pharmaceutical companies, is a defendant in a *qui tam* action brought in 1995 under the U.S. False Claims Act currently pending in the U.S. District Court for the Southern District of Florida. Watson Pharma has not been served in the *qui tam* action. A *qui tam* action is a civil lawsuit brought by an individual or a company (the *qui tam* relator) for an



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alleged violation of a federal statute, in which the U.S. Department of Justice has the right to intervene and take over the prosecution of the lawsuit at its option. Pursuant to applicable federal law, the *qui tam* action is under seal as to Watson Pharma. The Company believes that the *qui tam* action relates to whether allegedly improper price reporting by pharmaceutical manufacturers led to increased payments by Medicare and/or Medicaid. The *qui tam* action may seek to recover damages from Watson Pharma based on its price reporting practices. Watson Pharma subsequently also received and responded to notices or subpoenas from the Attorneys General of various states, including Florida, Nevada, New York, California and Texas, relating to pharmaceutical pricing issues and whether allegedly improper actions by pharmaceutical manufacturers led to excessive payments by Medicare and/or Medicaid. On June 26, 2003, the Company received a request for records and information from the U.S. House Committee on Energy and Commerce in connection with that committee's investigation into pharmaceutical reimbursements and rebates under Medicaid. The Company produced documents in response to the request. Other state and federal inquiries regarding pricing and reimbursement issues are anticipated.

Beginning in July 2002, the Company and certain of its subsidiaries, as well as numerous other pharmaceutical companies, were named as defendants in various state and federal court actions alleging improper or fraudulent reporting practices related to the reporting of average wholesale prices and wholesale acquisition costs of certain products, and that the defendants committed other improper acts in order to increase prices and market shares. Some of these actions have been consolidated in the U.S. District Court for the District of Massachusetts (*In re: Pharmaceutical Industry Average Wholesale Price Litigation, MDL Docket No. 1456*). The consolidated amended Class Action complaint in that case alleges that the defendants' acts improperly inflated the reimbursement amounts paid by various public and private plans and programs. The amended complaint alleges claims on behalf of a purported class of plaintiffs that paid any portion of the price of certain drugs, which price was calculated based on its average wholesale price, or contracted with a pharmacy benefit manager to provide others with such drugs. The Company filed an Answer to the Amended Consolidated Class Action Complaint on April 9, 2004. Defendants in the consolidated litigation have been divided into two groups. Certain defendants, referred to as the Track One defendants, have proceeded on an expedited basis. Classes were certified against these defendants, a trial has been completed with respect to some of the claims against this group of defendants, the presiding judge has issued a ruling granting judgment to the plaintiffs, that judgment is being appealed, and many of the claims have been settled. Other defendants, referred to as the Track Two Defendants, including the Company, have entered into a settlement agreement resolving all claims against the Track Two Defendants in the Consolidated Class Action. The total amount of the settlement for all of the Track Two Defendants is \$125 million. The amount to be paid by each Track Two Defendant is confidential. On July 2, 2008, the United States District Court for the District of Massachusetts preliminarily approved the Track Two settlement. On April 27, 2009, the Court held a hearing to further consider the fairness of the proposed Track Two settlement. The Court adjourned the hearing without ruling on the fairness of the proposed settlement until additional notices are provided to certain of the class members in the action. The settlement is not expected to materially adversely affect the Company's business, results of operations, financial condition and cash flows.

The Company and certain of its subsidiaries also are named as defendants in various lawsuits filed by numerous states and *qui tam* relators, including Texas, Kansas, Nevada, Montana, Massachusetts, Wisconsin, Kentucky, Alabama, Illinois, Mississippi, Florida, Arizona, Missouri, Alaska, Idaho, South Carolina, Hawaii, Utah, and Iowa captioned as follows: *State of Nevada v. American Home Products, et al., Civil Action No. 02-CV-12086-PBS, United States District Court for the District of Massachusetts; State of Montana v. Abbott Laboratories, et al., Civil Action No. 02-CV-12084-PBS, United States District Court for the District of Massachusetts; Commonwealth of Massachusetts v. Mylan Laboratories, et al., Civil Action No. 03-CV-11865-PBS, United States District Court for the District of Massachusetts; State of Wisconsin v. Abbott Laboratories, et al., Case No. 04-cv-1709, Wisconsin Circuit Court for Dane County; Commonwealth of Kentucky v. Alpharma, Inc., et al., Case Number 04-CI-1487, Kentucky Circuit Court for Franklin County; State of Alabama v. Abbott Laboratories, Inc. et al., Civil Action No. CV05-219, Alabama Circuit Court for Montgomery County; State of Illinois v. Abbott Laboratories, Inc. et al., Civil Action No. 05-CH-02474, Illinois Circuit Court for Cook County; State of Mississippi v. Abbott Laboratories, Inc. et al., Civil Action No. G2005-2021 S/2, Mississippi Chancery Court of Hinds County; State of Florida ex rel. Ven-A-Care,*



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*Leon County; State of Arizona ex rel. Terry Goddard, No. CV 2005-18711, Arizona Superior Court for Maricopa County; State of Missouri ex rel. Jeremiah W. (Jay) Nixon v. Mylan Laboratories, et al, Case No. 054-2486, Missouri Circuit Court of St. Louis; State of Alaska v. Alharma Branded Products Division Inc., et al., In the Superior Court for the State of Alaska Third Judicial District at Anchorage, C.A. No. 3AN-06-12026 CI; State of Idaho v. Alharma USPD Inc. et al., In the District Court of the Fourth Judicial District of the State of Idaho, in and for the County of Ada, C.A. No. CV0C-0701847; State of South Carolina and Henry D. McMaster v. Watson Pharmaceuticals (New Jersey), Inc., In the Court of Common Pleas for the Fifth Judicial Circuit, State of South Carolina, County of Richland, C.A. No. 2006-CP-40-7152; State of South Carolina and Henry D. McMaster v. Watson Pharmaceuticals (New Jersey), Inc., In the Court of Common Pleas for the Fifth Judicial Circuit, State of South Carolina, County of Richland, C.A. No. 2006-CP-40-7155; State of Hawaii v. Abbott Laboratories, Inc. et al., In the Circuit Court of the First Circuit, State of Hawaii, C.A. No. 06-1-0720-04 EEH; State of Utah v. Actavis U.S., Inc., et al., In the Third Judicial District Court of Salt Lake County, Civil No. 07-0913719; State of Iowa v. Abbott Laboratories, Inc., et al., In the U.S. District Court for the Southern District of Iowa, Central Division, Case No. 07-CV-00461; State of Texas ex rel. Ven-A-Care of the Florida Keys, Inc. v. Alharma Inc., et al, Case No. 08-001565, in the District Court of Travis County, Texas; and United States of America ex rel. Ven-A-Care of the Florida Keys, Inc.,v. Actavis Mid-Atlantic LLC, Civil Action No. 08-10852, in the U.S. District Court for the District of Massachusetts and State of Kansas ex rel. Steve Six v. Watson Pharmaceuticals, Inc. and Watson Pharma, Inc., Case Number: 08CV2228, District Court of Wyandotte County, Kansas, Civil Court Department.*

These cases generally allege that the defendants caused the plaintiffs to overpay pharmacies and other providers for prescription drugs under state Medicaid Programs by inflating the reported average wholesale price or wholesale acquisition cost, and by reporting false prices to the United States government under the Best Prices rebate program. Several of these cases also allege that state residents were required to make inflated copayments for drug purchases under the federal Medicare program, and companies were required to make inflated payments on prescription drug purchases for their employees. Many of these cases, some of which have been removed to federal court, are in the early stages of pleading or are proceeding through pretrial discovery. On January 20, 2006, the Company was dismissed without prejudice from the actions brought by the States of Montana and Nevada because the Company was not timely served. The case brought against the Company on behalf of Arizona was settled in May 2009 and was dismissed with prejudice on June 29, 2009. The case brought against the Company on behalf of Alabama was tried in June and July of 2009. At the conclusion of the trial, the jury was unable to reach a verdict, and the court declared a mistrial and ordered the case to be retried. A new trial date has not been set. The case brought against the Company on behalf of Kentucky had been scheduled for trial in September 2010, but that trial date was vacated and the case has been rescheduled for trial in November of 2011. The case brought against the Company on behalf of Mississippi has been scheduled for trial in December 2010. The case brought against the Company on behalf of Texas has been scheduled for trial in January 2011. The cases brought against the Company on behalf of Hawaii and Massachusetts have been settled.

The City of New York filed an action in the United States District Court for the Southern District of New York on August 4, 2004, against the Company and numerous other pharmaceutical defendants alleging similar claims. The case was transferred to the United States District Court for the District of Massachusetts, and was consolidated with several similar cases filed by individual New York counties. A corrected Consolidated Complaint was filed on June 22, 2005 ( *City of New York v. Abbott Laboratories, Inc., et al., Civil Action No. 01-CV-12257-PBS, United States District Court for the District of Massachusetts* ). The Consolidated Complaint included as plaintiffs the City of New York and 30 New York counties. Since the filing of the Consolidated Complaint, cases brought by a total of 14 additional New York counties have been transferred to the District of Massachusetts. On January 27, 2010, the U.S. District Court granted Plaintiffs' motion for partial summary judgment as to each of the generic defendants, including Watson, with respect to some of Watson's drugs reimbursed at the Federal Upper Limit, and found violations of New York's state false claims act statute. If final judgment is entered based upon this ruling, Plaintiffs will be entitled to compensatory damages, treble damages and penalties in amounts that are not currently known or reasonably estimatable. In February 2010, Watson and certain other defendants filed a motion to amend the Court's Order to certify an immediate interlocutory appeal,



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and seeking among other things, clarification of New York's false claims act statute. On May 4, 2010, the Court denied the motion. In February 2007, three of the New York counties' cases were sent back to New York state court (Erie, Oswego and Schenectady counties). On April 5, 2007, an additional action raising similar allegations was filed by Orange County, New York ( *County of Orange v. Abbott Laboratories, Inc., et al.* , United States District Court for the Southern District of New York, Case No. 07-CV-2777 ). The Company is therefore named as a defendant by the City of New York and 41 New York counties, consolidated in the District of Massachusetts case, as well as by four additional New York counties, with three of these cases pending in New York state courts. Many of the state and county cases are included in consolidated or single-case mediation proceedings, and the Company is participating in these proceedings.

In December 2009, the Company learned that numerous pharmaceutical companies, including certain subsidiaries of the Company, have been named as defendants in a qui tam action pending in the United States District Court for the District of Massachusetts ( *United States of America ex rel. Constance A. Conrad v. Actavis Mid-Atlantic, LLC, f/k/a Biovail Pharmaceuticals, LLC, et. al.*, USDC Case No. 02-CV-11738-NG). The seventh amended complaint, which was served on certain of the Company's subsidiaries in December 2009, alleges that the defendants falsely reported to the United States that certain pharmaceutical products were eligible for Medicaid reimbursement and thereby allegedly caused false claims for payment to be made through the Medicaid program.

Additional actions by other states, cities and/or counties are anticipated. These actions and/or the actions described above, if successful, could adversely affect the Company and may have a material adverse effect on the Company's business, results of operations, financial condition and cash flows.

*FDA Matters.* In May 2002, Watson reached an agreement with the FDA on the terms of a consent decree with respect to its Corona, California manufacturing facility. The court approved the consent decree on May 13, 2002 ( *United States of America v. Watson Laboratories, Inc., and Allen Y. Chao* , United States District Court for the Central District of California, EDCV-02-412-VAP). The consent decree with the FDA does not require any fine, a facility shutdown, product recalls or any reduction in production or service at the Company's Corona facility. The consent decree applies only to the Corona facility and not other manufacturing sites. On July 9, 2008, the court entered an order dismissing Allen Y. Chao, the Company's former President and Chief Executive Officer, from the action and from the consent decree. The decree requires Watson to ensure that its Corona, California facility complies with the FDA's current Good Manufacturing Practices ( cGMP ) regulations.

Pursuant to the agreement, Watson hired an independent expert to conduct inspections of the Corona facility at least once each year. In December 2002, February 2003, January 2004, January 2005, January 2006, January 2007, January-February 2008, January 2009, and January 2010, respectively, the first, second, third, fourth, fifth, sixth, seventh and eighth annual inspections were completed and the independent expert submitted its report of the inspection to the FDA. In each instance, the independent expert reported its opinion that, based on the findings of the audit of the facility, the FDA's applicable cGMP requirements, applicable FDA regulatory guidance, and the collective knowledge, education, qualifications and experience of the expert's auditors and reviewers, the systems at Watson's Corona facility audited and evaluated by the expert are in compliance with the FDA's cGMP regulations. However, the FDA is not required to accept or agree with the independent expert's opinion. The FDA conducted an inspection of that facility from March 31, 2004 until May 6, 2004. At the conclusion of the inspection, the FDA issued a Form 483 listing the observations made during the inspection, including observations related to certain laboratory test methods and other procedures in place at the facility. In June 2004 the Company submitted its response to the FDA Form 483 inspectional observations and met with FDA officials to discuss its response, including the corrective actions the Company had taken, and intended to take, to address the inspectional observations. The FDA conducted another inspection of the facility from April 5, 2005 through April 13, 2005. At the conclusion of the inspection no formal observations were made and no FDA Form 483 was issued. The FDA conducted another inspection of the facility from July 10, 2006 through July 21, 2006. At the conclusion of the inspection no formal observations were made and no FDA Form 483 was issued. From



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February 20, 2007 through March 9, 2007, the FDA conducted another inspection of the facility. At the conclusion of the inspection, the FDA issued a Form 483 listing the observations made during the inspection. In March 2007 the Company submitted its response to the FDA Form 483 inspectional observations, including the corrective actions the Company has taken to address the inspectional observations. The FDA conducted another inspection of the facility from October 18, 2007 through October 26, 2007. At the conclusion of the inspection, the FDA issued a Form 483 listing two observations made during the pre-approval portion of the inspection related to two pending Abbreviated New Drug Applications (ANDAs). No formal observations were made concerning the Company's compliance with cGMP. The FDA conducted another inspection of the facility from June 16, 2008 through July 1, 2008. At the conclusion of the inspection no formal observations were made and no FDA Form 483 was issued. The FDA conducted another inspection of the facility from September 21, 2009 through September 24, 2009. At the conclusion of the inspection no formal observations were made and no FDA Form 483 was issued. However, if in the future, the FDA determines that, with respect to its Corona facility, Watson has failed to comply with the consent decree or FDA regulations, including cGMPs, or has failed to adequately address the observations in the Form 483, the consent decree allows the FDA to order Watson to take a variety of actions to remedy the deficiencies. These actions could include ceasing manufacturing and related operations at the Corona facility, and recalling affected products. Such actions, if taken by the FDA, could have a material adverse effect on the Company, its results of operations, financial position and cash flows.

*Federal Trade Commission Investigations.* The Company has received Civil Investigative Demands or requests for information from the Federal Trade Commission seeking information and documents related to the terms on which the Company has settled lawsuits initiated by patentees under the Hatch-Waxman Act, and other commercial arrangements between the Company and third parties. These investigations relate to the Company's August 2006 settlement with Cephalon, Inc. related to the Company's generic version of Provigil® (modafinil), and its April 2007 agreement with Sandoz, Inc. related to the Company's forfeiture of its entitlement to 180 days of marketing exclusivity for its 50 milligram dosage strength of its generic version of Toprol XL® (metoprolol succinate xl). The Company believes these agreements comply with applicable laws and rules. However, if the Federal Trade Commission concludes that any of these agreements violate applicable antitrust laws or rules, it could initiate legal action against the Company. These actions, if successful, could have a material adverse effect on the Company's business, results of operations, financial condition and cash flows.

*AndroGel® Antitrust Litigation.* On January 29, 2009, the U.S. Federal Trade Commission and the State of California filed a lawsuit in the United States District Court for the Central District of California (*Federal Trade Commission, et. al. v. Watson Pharmaceuticals, Inc., et. al., USDC Case No. CV 09-00598*) alleging that the Company's September 2006 patent lawsuit settlement with Solvay Pharmaceuticals, Inc., related to AndroGel® 1% (testosterone gel) CIII is unlawful. The complaint generally alleges that the Company improperly delayed its launch of a generic version of AndroGel® in exchange for Solvay's agreement to permit the Company to co-promote AndroGel® for consideration in excess of the fair value of the services provided by the Company. The complaint alleges violation of federal and state antitrust and consumer protection laws and seeks equitable relief and civil penalties. On February 2 and 3, 2009, three separate lawsuits alleging similar claims were filed in the United States District Court for the Central District of California by various private plaintiffs purporting to represent certain classes of similarly situated claimants. (*Meijer, Inc., et. al., v. Unimed Pharmaceuticals, Inc., et. al., USDC Case No. EDCV 09-0215*); (*Rochester Drug Co-Operative, Inc. v. Unimed Pharmaceuticals Inc., et. al., Case No. EDCV 09-0226*); (*Louisiana Wholesale Drug Co. Inc. v. Unimed Pharmaceuticals Inc., et. al, Case No. EDCV 09-0228*). On April 8, 2009, the Court granted the defendants' motion to transfer and transferred the cases to the Northern District of Georgia. On April 21, 2009 the State of California voluntarily dismissed its lawsuit against the Company without prejudice. The Federal Trade Commission and the private plaintiffs in the Northern District of Georgia filed amended complaints on May 28, 2009. The private plaintiffs amended their complaints to include allegations concerning conduct before the U.S. Patent and Trademark Office, conduct in connection with the listing of Solvay's patent in the Food and Drug Administration's Orange Book, and sham litigation. On July 20, 2009, and August 31, 2009, the defendants (including the Company) filed motions to dismiss the Federal Trade Commission action and the private plaintiff actions, respectively. On March 31, April 17, and April 21, 2009, additional actions alleging similar claims were filed in the United States

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Court for the District of New Jersey ( *Stephen L. LaFrance Pharm., Inc. d/b/a SAJ Dist. v. Unimed Pharms., Inc., et al.*, Civ. No. 09-1507 ); ( *Fraternal Order of Police, Fort Lauderdale Lodge 31, Insurance Trust Fund v. Unimed Pharms. Inc., et al.*, Civ. No. 09-1856 ); ( *Scurto v. Unimed Pharms., Inc., et al.*, Civ. No. 09-1900 ). These actions purport to assert similar claims on behalf of various class representatives. On April 20, 2009, the Company was dismissed without prejudice from the *Stephen L. LaFrance* action pending in the District of New Jersey. On June 2, 2009, a District of New Jersey magistrate judge granted the defendants' motion to transfer, and denied the plaintiffs' motion for reconsideration of that decision on June 24, 2009. On July 13, 2009, the plaintiffs appealed the magistrate judge's decision transferring the cases to the district court judge, and on September 30, 2009 the district court judge affirmed the magistrate's decision transferring the actions to the Northern District of Georgia. On May 19, 2009, an additional action alleging similar claims was filed in the District of Minnesota ( *United Food and Commercial Workers Unions and Employers Midwest Health Benefits Fund v. Unimed Pharms., Inc., et al.*, Civ. No. 09-1168 ). This action purports to assert similar claims on behalf of a putative class of indirect purchasers of AndroGel<sup>®</sup>. On June 10, 2009, the defendants (including the Company) filed a motion to transfer the *United Food and Commercial Workers* action to the Northern District of Georgia. On June 11, 2009, the *United Food and Commercial Workers* plaintiff filed a motion to have all of the private plaintiff cases consolidated under the Multidistrict Litigation rules of the federal courts. On June 17 and 29, 2009, two additional actions alleging similar claims were filed in the Middle District of Pennsylvania ( *Rite Aid Corp. et al. v. Unimed Pharms., Inc. et al.*, Civ. No. 09-1153, and *Walgreen Co., et al. v. Unimed Pharms., Inc., et al.*, Civ. No. 09-1240 ), by plaintiffs purporting to be direct purchasers of AndroGel<sup>®</sup>. On June 22, 2009, the *Rite Aid* plaintiffs filed a motion to have all of the private plaintiff cases consolidated under the Multidistrict Litigation rules of the federal courts. On July 22, 2009, the defendants (including the Company) filed motions to transfer the *Rite Aid* and *Walgreen* actions from the Middle District of Pennsylvania to the Northern District of Georgia. On October 5, 2009, the Judicial Panel on Multidistrict Litigation transferred all actions pending outside of the Northern District of Georgia to that district for consolidated pre-trial proceedings ( *In re: AndroGel<sup>®</sup> Antitrust Litigation (No. II)*, MDL Docket No. 2084 ). On October 15, 2009, the judge presiding over the consolidated litigations ordered all direct purchaser plaintiffs ( *Meijer Inc., Rochester Drug Co-Operative, Inc., Louisiana Wholesale Drug Co. Inc., Rite Aid Corp., Walgreen Co., and Stephen L. LaFrance Pharm., Inc.* ) to file a consolidated opposition to the Company's pending motion to dismiss. The consolidated opposition was filed on October 28, 2009. On October 30, 2009, the defendants moved to dismiss the complaints filed by the indirect purchaser plaintiffs. All of the aforementioned lawsuits related to AndroGel<sup>®</sup> are now pending in the United States District Court for the Northern District of Georgia. On February 22, 2010, the judge presiding over the consolidated litigations granted the Company's motions to dismiss the complaints, except the portion of private plaintiffs' complaints that include allegations concerning sham litigation. On March 5, 2010, the plaintiff in the *Fraternal Order of Police* action filed a motion for leave to amend its complaint to add allegations concerning conduct before the U.S. Patent and Trademark Office, conduct in connection with the listing of Solvay's patent in the Food and Drug Administration's Orange Book, and sham litigation similar to the claims raised in the direct purchaser actions. Defendants (including the Company) did not oppose the motion to amend and it is currently pending. On April 7, 2010, an additional action alleging similar claims to the pending direct purchaser actions was filed in the Northern District of Georgia ( *Supervalu, Inc. v. Unimed Pharms., LLC, et al.*, Civ. No. 10-1024 ) by a plaintiff purporting to be a direct purchaser of AndroGel<sup>®</sup>. On April 30, 2010, all parties to the *Supervalu* action (including the Company) filed a joint motion to consolidate this action with the other direct purchaser actions. On May 3, 2010 the court granted the motion. Discovery in the direct purchaser actions is ongoing. Final judgment was entered in the Federal Trade Commission's action on April 21, 2010.

On October 30, 2009, an additional action raising similar allegations under Tennessee state law was filed in the Circuit Court for Cocke County, Tennessee ( *Jabo's Pharmacy Inc. v. Solvay Pharmaceuticals, Inc., et al.*, Case No. 31,837 ). On December 4, 2009, the defendants (including the Company) removed the case to the United States District Court for the Eastern District of Tennessee, Greeneville Division. Also on December 4, 2009, the Company filed a motion with the Judicial Panel on Multidistrict Litigation requesting that the Tennessee action be centralized with all the other cases relating to AndroGel<sup>®</sup> in the United States District Court for the Northern District of Georgia. On December 16, 2009, the Judicial Panel on Multidistrict Litigation issued a Conditional Transfer Order. On December 30, 2009, Plaintiff filed a motion to vacate the Conditional Transfer Order, which motion is currently

pending. On January 13, 2010, Plaintiff filed a motion to remand the action to Tennessee state

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court; the motion has been briefed and is currently pending. On April 5, 2010, the Judicial Panel on Multidistrict Litigation transferred the *Jabos* action to the Northern District of Georgia. It is now part of the multidistrict litigation pending there.

The Company believes that these actions are without merit and intends to defend itself vigorously. However, these actions, if successful, could have a material adverse effect on the Company's business, results of operations, financial condition and cash flows.

*Hormone Replacement Therapy Litigation.* Beginning in early 2004, a number of product liability suits were filed against the Company and certain Company affiliates, for personal injuries allegedly arising out of the use of hormone replacement therapy products, including but not limited to estropipate and estradiol. These complaints also name numerous other pharmaceutical companies as defendants, and allege various injuries, including ovarian cancer, breast cancer and blood clots. Approximately 102 cases are pending against Watson and/or its affiliates in state and federal courts representing claims by approximately 155 plaintiffs. Many of the cases involve multiple plaintiffs. The majority of the cases have been transferred to and consolidated in the United States District Court for the Eastern District of Arkansas ( *In re: Prempro Products Liability Litigation, MDL Docket No. 1507* ). Discovery in these cases is ongoing. The Company maintains product liability insurance against such claims. However, these actions, if successful, or if insurance does not provide sufficient coverage against the claims, could adversely affect the Company and could have a material adverse effect on the Company's business, results of operations, financial condition and cash flows.

*Levonorgestrel/Ethinyl Estradiol Tablets (Seasonale®).* On December 13, 2007, Duramed Pharmaceuticals, Inc. sued the Company and certain of its subsidiaries in the United States District Court for the District of New Jersey, alleging that sales of the Company's Quasens™ (levonorgestrel/ethinyl estradiol) tablets, the generic version of Duramed's Seasonal® tablets, infringes Duramed's U.S. Patent No. RE 39,861 ( *Duramed Pharmaceuticals, Inc. v. Watson Pharmaceuticals, Inc., et. al., Case No. 07cv05941* ). The complaint sought damages and injunctive relief. On March 3, 2008, the Company answered the complaint. On May 7, 2010, the parties settled the lawsuit. Pursuant to the terms of the settlement, the Company paid an undisclosed amount to the plaintiff and received a release of all claims and a fully paid up license to the patent in dispute. Other terms of the settlement are confidential.

*Medical West Ballas Pharmacy, LTD, et al. v. Anda, Inc.,* (Circuit Court of the County of St. Louis, State of Missouri, Case No. 08SL-CC00257). In January 2008, Medical West Ballas Pharmacy, LTD, filed a purported class action complaint against the Company alleging conversion and alleged violations of the Telephone Consumer Protection Act ( TCPA ) and Missouri Consumer Fraud and Deceptive Business Practices Act. In April 2008, plaintiff filed an amended complaint substituting Anda, Inc., a subsidiary of the Company, as the defendant. The amended complaint alleges that by sending unsolicited facsimile advertisements, Anda misappropriated the class members paper, toner, ink and employee time when they received the alleged unsolicited faxes, and that the alleged unsolicited facsimile advertisements were sent to the plaintiff in violation of the TCPA and Missouri Consumer Fraud and Deceptive Business Practices Act. The complaint seeks to assert class action claims on behalf of the plaintiff and other similarly situated third parties. In April 2008, Anda filed an answer to the amended complaint, denying the allegations. In November 2009, the court granted plaintiff's motion to expand class of plaintiffs from individuals for which Anda lacked evidence of express permission or an established business relationship to All persons who on or after four years prior to the filing of this action, were sent telephone facsimile messages advertising pharmaceutical drugs and products by or on behalf of Defendant. Discovery in the action is ongoing. No trial date has been set. Anda intends to defend the action vigorously. However, this action, if successful, could have an adverse effect on the Company's business, results of operations, financial condition and cash flows.

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Watson and its affiliates are involved in various other disputes, governmental and/or regulatory inspections, inquires, investigations and proceedings that could result in litigation, and other litigation matters that arise from time to time. The process of resolving matters through litigation or other means is inherently uncertain and it is possible that an unfavorable resolution of these matters will adversely affect the Company, its results of operations, financial condition and cash flows.

**NOTE 13 SUBSEQUENT EVENT**

On May 10, 2010, a subsidiary of the Company entered into a one year consulting agreement with Anthony Selwyn Tabatznik, a director of the Company.

In May 2010, the Company approved and announced a plan to close its Canadian manufacturing facility by the end of 2011 and transfer production to our other manufacturing facilities where we have excess capacity. We expect to incur costs in 2010 related to the closure of the facility and transfer of production of approximately \$17.0 million which includes accelerated depreciation, severance, retention and product transfer costs. Total costs expected to be incurred by the end of 2011 total approximately \$40.0 million.

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following discussion of our financial condition and the results of operations should be read in conjunction with the Condensed Consolidated Financial Statements and notes thereto included elsewhere in this Quarterly Report on Form 10-Q ( Quarterly Report ). This discussion contains forward-looking statements that are subject to known and unknown risks, uncertainties and other factors that may cause our actual results to differ materially from those expressed or implied by such forward-looking statements. These risks, uncertainties and other factors include, among others, those identified under Cautionary Note Regarding Forward-Looking Statements in our Annual Report on Form 10-K for the year ended December 31, 2009, and elsewhere in this Quarterly Report.

**Overview of Watson**

Watson Pharmaceuticals, Inc. ( Watson , the Company , we , us or our ) was incorporated in 1985 and is engaged in the development, manufacturing, marketing, sale and distribution of brand and off-patent (generic) pharmaceutical products. Watson operates manufacturing, distribution, research and development ( R&D ), and administrative facilities in the United States of America ( U.S. ) and , beginning in 2009, in key international markets including Western Europe, Canada, Australasia, Asia, South America and South Africa.

**Merger Agreement with Arrow Group**

On December 2, 2009, Watson completed its acquisition of all the outstanding shares of common stock of Robin Hood Holdings Limited, a Malta private limited liability company, and Cobalt Laboratories, Inc., a Delaware corporation (together the Arrow Group ) for cash, stock and certain contingent consideration (the Arrow Acquisition ). In accordance with the terms of the share purchase agreement dated June 16, 2009, as amended on November 26, 2009 (together the Acquisition Agreement ), the Company acquired all the outstanding shares of common stock of the Arrow Group for the following consideration:

- The payment of cash and the assumption of certain liabilities totaling \$1.05 billion;
- Approximately 16.9 million restricted shares of Common Stock of Watson (the Restricted Common Stock );
- 200,000 shares of newly designated mandatorily redeemable, non-voting Series A Preferred Stock of Watson (the Mandatorily Redeemable Preferred Stock ) placed in an indemnity escrow account for the benefit of the former shareholders of the Arrow Group (the Arrow Selling Shareholders ); and
- Certain contingent consideration based on the after-tax gross profits on sales of the authorized generic version of Lipitor® (atorvastatin) in the U. S. calculated and payable as described in the Acquisition Agreement.

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As a result of the Arrow Acquisition, Watson also acquired a 36% ownership interest in Eden Biopharm Group ( Eden ), a company which provides development and manufacturing services for early-stage biotech companies, which will provide a long-term foundation for generic biologics. In January, 2010, we purchased the remaining interest in Eden for \$15.0 million. Eden results are included in our Global Brand division and Eden will maintain its established contract services model, while providing the Company with biopharmaceutical development and manufacturing capabilities.

**Segments**

Watson has three reportable operating segments: Global Generic, Global Brand and Distribution. The Global Generic segment includes off-patent pharmaceutical products that are therapeutically equivalent to proprietary products. The Global Brand segment includes patent-protected products and certain trademarked off-patent products that Watson sells and markets as brand pharmaceutical products. The Distribution segment mainly distributes generic pharmaceutical products manufactured by third parties, as well as by Watson, primarily to independent pharmacies, pharmacy chains, pharmacy buying groups and physicians' offices under the Anda trade name. Sales are principally generated through a combination of national sales representatives, an in-house telemarketing staff and through internally developed ordering systems. The Distribution segment operating results exclude sales by Anda of products developed, acquired, or licensed by Watson's Global Generic and Global Brand segments. Arrow results are included in the Global Generic segment except for results from Eden which are included in our Global Brand segment.

The Company evaluates segment performance based on segment net revenues and segment contribution. Segment contribution represents segment net revenues less direct segment operating expenses. The Company does not report total assets, capital expenditures, corporate general and administrative expenses, amortization, gains on disposal or impairment losses by segment as such information has not been used by management, or has not been accounted for at the segment level.

**Global Supply Chain Initiative**

During the first quarter of 2008, we announced steps to improve our operating cost structure and achieve operating efficiencies through our Global Supply Chain Initiative which includes the planned closure of manufacturing facilities in Carmel, New York, our distribution center in Brewster, New York and the transition of manufacturing to our other manufacturing locations within the U.S. and India. Distribution activities at our distribution center in Brewster, New York ceased in July 2009. We anticipate the successful transition of product manufacturing and the completion of related facility rationalization activities will permit the closure of manufacturing facilities in Carmel, New York by the end of 2010.

In May 2010, the Company approved and announced a plan to close its Canadian manufacturing facility by the end of 2011 and transfer production to our other manufacturing facilities where we have excess capacity. We expect to incur costs in 2010 related to the closure of the facility and transfer of production of approximately \$17.0 million which includes accelerated depreciation, severance, retention and product transfer costs. Total costs expected to be incurred by the end of 2011 total approximately \$40.0 million.

**Table of Contents****Three Months Ended March 31, 2010 Compared to Three Months Ended March 31, 2009**

Results of operations, including segment net revenues, segment operating expenses and segment contribution information for the Company's Global Generic, Global Brand and Distribution segments, consisted of the following (in millions):

	<b>Three Months Ended March 31, 2010</b>				<b>Three Months Ended March 31, 2009</b>			
	<b>Generic</b>	<b>Brand</b>	<b>Distribution</b>	<b>Total</b>	<b>Generic</b>	<b>Brand</b>	<b>Distribution</b>	<b>Total</b>
Product sales	\$ 534.1	\$ 72.4	\$ 221.4	\$ 827.9	\$ 395.2	\$ 98.2	\$ 153.7	\$ 647.1
Other	9.7	18.9		28.6	6.5	13.8		20.3
Net revenues	543.8	91.3	221.4	856.5	401.7	112.0	153.7	667.4
Operating expenses:								
Cost of sales <sup>(1)</sup>	287.5	24.7	192.5	504.7	238.5	24.2	126.0	388.7
Research and development	42.2	17.3		&nb				