LANNETT CO INC
Form 10-Q
November 12, 2009
Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934**

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2009

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934**

FOR THE TRANSITION PERIOD FROM TO .

Commission File No. 001-31298

LANNETT COMPANY, INC.

(Exact Name of Registrant as Specified in its Charter)

State of Delaware	**23-0787699**
(State of Incorporation)	(I.R.S. Employer I.D. No.)

9000 State Road

Philadelphia, PA 19136

(215) 333-9000

(Address of principal executive offices and telephone number)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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 x No o**

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. (Check one):

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

Indicate by check mark whether the registrant 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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

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

Indicate the number of shares outstanding of each class of the registrant s common stock, as of the latest practical date.

Class	**Outstanding as of November 9, 2009**
Common stock, par value $0.001 per share	24,699,089 shares

Table of Contents

Table of Contents

		Page No.
PART I. FINANCIAL INFORMATION		
ITEM 1.	**FINANCIAL STATEMENTS**	
	Consolidated Balance Sheets as of September 30, 2009 (unaudited) and June 30, 2009	1
	Consolidated Statements of Operations (unaudited) for the three months ended September 30, 2009 and 2008	2
	Consolidated Statement of Changes in Shareholders Equity (unaudited) for the three months ended September 30, 2009	3
	Consolidated Statements of Cash Flows (unaudited) for the three months ended September 30, 2009 and 2008	4
	Notes to Consolidated Financial Statements (unaudited)	5
ITEM 2.	**MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**	27
ITEM 3.	**QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**	38
ITEM 4.	**CONTROLS AND PROCEDURES**	38
PART II. OTHER INFORMATION		
ITEM 1.	**LEGAL PROCEEDINGS**	39
ITEM 4.	**SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**	40
ITEM 6.	**EXHIBITS**	40

CERTIFICATION OF PRESIDENT & CHIEF EXECUTIVE OFFICER

CERTIFICATION OF CHIEF FINANCIAL OFFICER

CERTIFICATION PURSUANT TO SECTION 906 OF SARBANES OXLEY ACT OF 2002

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

LANNETT COMPANY, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

		(Unaudited) September 30, 2009		June 30, 2009
ASSETS				
Current Assets				
Cash and cash equivalents	$	23,611,254	$	25,832,456
Investment securities - available for sale		747,448		347,921
Trade accounts receivable (net of allowance of $132,000 and $132,000, respectively)		30,891,483		29,945,748
Inventories, net		17,010,224		16,195,361
Interest receivable		92,770		90,425
Deferred tax assets		4,346,311		4,296,929
Other current assets		541,848		602,335
Total Current Assets		77,241,338		77,311,175
Property, plant and equipment		41,771,570		41,431,158
Less accumulated depreciation		(19,242,024)		(18,533,773)
		22,529,546		22,897,385
Construction in progress		1,318,534		591,685
Investment securities - available for sale		398,470		801,748
Intangible assets (product rights) - net of accumulated amortization		9,160,357		9,118,710
Deferred tax assets		13,321,236		13,757,545
Other assets		89,846		98,873
Total Assets	$	124,059,327	$	124,577,121
LIABILITIES AND SHAREHOLDERS EQUITY				
LIABILITIES				
Current Liabilities				
Accounts payable	$	15,649,685	$	16,805,468
Accrued expenses		2,132,314		1,842,434
Accrued payroll and payroll related		2,954,609		5,150,104
Income taxes payable		1,224,663		711,073
Current portion of long-term debt		357,806		435,386
Rebates, chargebacks and returns payable		12,656,106		13,734,540
Total Current Liabilities		34,975,183		38,679,005
Long-term debt, less current portion		7,644,677		7,703,382
Unearned grant funds		500,000		500,000
Other long-term liabilities		11,693		47,111
Total Liabilities		43,131,553		46,929,498
Commitment and Contingencies, See notes 10 and 11				
SHAREHOLDERS EQUITY				
Common stock - authorized 50,000,000 shares, par value $0.001;				
issued and outstanding, 24,587,281 and 24,517,696 shares, respectively		24,587		24,518
Additional paid in capital		76,733,498		76,250,309
Retained earnings		4,600,935		1,743,565
Noncontrolling interest		104,548		93,654
Accumulated other comprehensive income		22,500		24,751
		81,486,068		78,136,797
Less: Treasury stock at cost - 90,160 and 82,228 shares, respectively		(558,294)		(489,174)
TOTAL SHAREHOLDERS EQUITY		80,927,774		77,647,623
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$	124,059,327	$	124,577,121

The accompanying notes to consolidated financial statements are an integral part of these statements.

Table of Contents

LANNETT COMPANY, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

	Three months ended September 30,	
	2009	**2008**
Net sales	$ 31,434,989	$ 25,567,653
Cost of sales	19,012,318	16,120,195
Amortization of intangible assets	448,667	446,166
Product royalties	439,774	
Gross profit	11,534,230	9,001,292
Research and development expenses	3,027,841	1,863,113
Selling, general, and administrative expenses	3,763,161	4,949,144
Loss on sale of investments		4,931
Operating income	4,743,228	2,184,104
Interest income	23,099	45,767
Interest expense	(70,413)	(66,209)
	(47,314)	(20,442)
Income before income tax expense	4,695,914	2,163,662
Income tax expense	1,827,650	919,990
Consolidated net income	2,868,264	1,243,672
Less net income from noncontrolling interest	(10,894)	(17,507)
Net income attributable to Lannett Company, Inc.	$ 2,857,370	$ 1,226,165
Basic income per common share - Lannett Company, Inc.	$ 0.12	$ 0.05
Diluted income per common share - Lannett Company, Inc.	$ 0.11	$ 0.05
Basic weighted average number of shares	24,533,562	24,306,488
Diluted weighted average number of shares	25,054,661	24,382,951

The accompanying notes to consolidated financial statements are an integral part of these statements.

Table of Contents

LANNETT COMPANY, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS EQUITY

(UNAUDITED)

	Common Stock		Additional				Accum. Other	
	Shares Issued	Amount	Paid-in Capital	Retained Earnings	Treasury Stock	Noncontrolling Interest	Comprehensive Income (loss)	Shareholders Equity
Balance, June 30, 2009	24,517,696	$ 24,518	$ 76,250,309	$ 1,743,565	$ (489,174)	$ 93,654	$ 24,751	$ 77,647,623
Exercise of stock options	36,100	36	152,650					152,686
Shares issued in connection with employee stock purchase plan	7,985	8	33,249					33,257
Share based compensation								
Restricted stock			43,007					43,007
Stock options			232,868					232,868
Employee stock purchase plan			21,440					21,440
Shares issued in connection with restricted stock grant	25,500	25	(25)					
Purchase of treasury stock					(69,120)			(69,120)
Income from noncontrolling interest						10,894		10,894
Other comprehensive loss, net of income tax							(2,251)	(2,251)
Net income				2,857,370				2,857,370
Balance, September 30, 2009	24,587,281	$ 24,587	$ 76,733,498	$ 4,600,935	$ (558,294)	$ 104,548	$ 22,500	$ 80,927,774

The accompanying notes to consolidated financial statements are an integral part of these statements.

Table of Contents

LANNETT COMPANY, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	For the three months ended September 30, 2009	2008
OPERATING ACTIVITIES:		
Net income - Lannett Company, Inc.	$ 2,857,370	$ 1,226,165
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation and amortization	1,166,604	1,283,617
Deferred tax expense	388,427	911,872
Stock compensation expense	297,315	389,797
Other noncash (income) expenses	(26,391)	1,949
Income from noncontrolling interest	10,894	17,506
Changes in assets and liabilities which provided (used) cash:		
Trade accounts receivable	(1,152,466)	5,341,230
Inventories	(814,863)	294,571
Prepaid and income taxes payable	513,590	784,009
Prepaid expenses and other assets	58,142	(106,188)
Accounts payable	(1,155,783)	(1,259,114)
Accrued expenses	289,880	157,703
Rebates, chargebacks and returns payable	(871,703)	20,132
Accrued payroll and payroll related	(2,195,495)	398,639
Deferred revenue		(258,283)
Net cash (used in) provided by operating activities	(634,479)	9,203,605
INVESTING ACTIVITIES:		
Purchases of property, plant and equipment (including construction in progress)	(1,067,261)	(209,210)
Purchase of intangible asset (product rights)	(500,000)	
Proceeds from sale of investment securities - available for sale		316,099
Purchase of investment securities - available for sale		(298,528)
Net cash used in investing activities	(1,567,261)	(191,639)
FINANCING ACTIVITIES:		
Repayments of debt	(136,285)	(147,583)
Proceeds from issuance of stock	185,943	31,281
Purchase of treasury stock	(69,120)	(19,950)
Net cash used in financing activities	(19,462)	(136,252)
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(2,221,202)	8,875,714
CASH AND CASH EQUIVLAENTS, BEGINNING OF PERIOD	25,832,456	6,256,712
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 23,611,254	$ 15,132,426
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION -		
Interest paid	$ 41,762	$ 64,852
Income taxes paid	$ 925,633	$ 250,000
Lannett stock issued - contingent consideration - Cody Labs acquistion	$	$ 430,500

The accompanying notes to consolidated financial statements are an integral part of these statements.

Table of Contents

LANNETT COMPANY, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - UNAUDITED

Note 1. Interim Financial Information

The accompanying unaudited financial statements have been prepared in accordance with U.S. generally accepted accounting principles for presentation of interim financial statements and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, the unaudited financial statements do not include all the information and footnotes necessary for a comprehensive presentation of the financial position, results of operations, and cash flows for the periods presented. In the opinion of management, the unaudited financial statements include all the normal recurring adjustments that are necessary for a fair presentation of the financial position, results of operations, and cash flows for the periods presented. Operating results for the three months ended September 30, 2009 are not necessarily indicative of the results that may be expected for the fiscal year ending June 30, 2010. You should read these unaudited financial statements in combination with the other Notes in this section; Management s Discussion and Analysis of Financial Condition and Results of Operations appearing in Item 2; and the Financial Statements, including the Notes to the Financial Statements, included in our Annual Report on Form 10-K for the fiscal year ended June 30, 2009.

Note 2. Summary of Significant Accounting Policies

Lannett Company, Inc., a Delaware corporation, and subsidiaries (the Company or Lannett), develop, manufacture, package, market, and distribute active pharmaceutical ingredients as well as pharmaceutical products sold under generic chemical names. The Company primarily manufactures solid oral dosage forms, including tablets and capsules, and is pursuing partnerships and research contracts for the development and production of other dosage forms, including liquids and injectable products.

Use of Estimates The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. As applicable to these consolidated financial statements, the most significant estimates and assumptions relate to sales reserves and allowances, income taxes, inventories, contingencies and valuation of intangible assets.

Principles of Consolidation - The consolidated financial statements include the accounts of the operating parent company, Lannett Company, Inc., and its wholly owned subsidiaries, Lannett Holdings, Inc. and Cody Laboratories, Inc. (Cody). Cody includes the consolidation of Cody LCI Realty, LLC, a variable interest entity. See Note 16 regarding the consolidation of this variable interest entity. All intercompany accounts and transactions have been eliminated.

Reclassifications - Certain prior year amounts have been reclassified to conform to the current year financial statement presentation.

Revenue Recognition - The Company recognizes revenue when its products are shipped. At this point, title and risk of loss have transferred to the customer and provisions for estimates, including rebates, promotional adjustments, price adjustments, returns, chargebacks, and other potential adjustments are reasonably

Table of Contents

determinable. Accruals for these provisions are presented in the consolidated financial statements as rebates, chargebacks and returns payable and reductions to net sales. The change in the reserves for various sales adjustments may not be proportionally equal to the change in sales because of changes in both the product and the customer mix. Increased sales to wholesalers will generally require additional accruals as they are the primary recipient of chargebacks and rebates. Incentives offered to secure sales vary from product to product. Provisions for estimated rebates and promotional credits are estimated based upon contractual terms. Provisions for other customer credits, such as price adjustments, returns, and chargebacks, require management to make subjective judgments on customer mix. Unlike branded innovator drug companies, Lannett does not use information about product levels in distribution channels from third-party sources, such as IMS and NDC Health, in estimating future returns and other credits. Lannett calculates a chargeback/rebate rate based on contractual terms with its customers and applies this rate to customer sales. The only variable is customer mix, and this assumption is based on historical data and sales expectations.

Chargebacks The provision for chargebacks is the most significant and complex estimate used in the recognition of revenue. The Company sells its products directly to wholesale distributors, generic distributors, retail pharmacy chains, and mail-order pharmacies. The Company also sells its products indirectly to independent pharmacies, managed care organizations, hospitals, nursing homes, and group purchasing organizations, collectively referred to as indirect customers. Lannett enters into agreements with its indirect customers to establish pricing for certain products. The indirect customers then independently select a wholesaler from which to actually purchase the products at these agreed-upon prices. Lannett will provide credit to the wholesaler for the difference between the agreed-upon price with the indirect customer and the wholesaler s invoice price if the price sold to the indirect customer is lower than the direct price to the wholesaler. This credit is called a chargeback. The provision for chargebacks is based on expected sell-through levels by the Company s wholesale customers to the indirect customers and estimated wholesaler inventory levels. As sales to the large wholesale customers, such as Cardinal Health, AmerisourceBergen, and McKesson increase, the reserve for chargebacks will also generally increase. However, the size of the increase depends on the product mix and the amount of those sales that end up at indirect customers with which the Company has specific chargeback agreements. The Company continually monitors the reserve for chargebacks and makes adjustments when management believes that expected chargebacks on actual sales may differ from actual chargeback reserves.

Rebates Rebates are offered to the Company s key chain drug store, distributor and wholesaler customers to promote customer loyalty and increase product sales. These rebate programs provide customers with rebate credits upon attainment of pre-established volumes or attainment of net sales milestones for a specified period. Other promotional programs are incentive programs offered to the customers. At the time of shipment, the Company estimates reserves for rebates and other promotional credit programs based on the specific terms in each agreement. The reserve for rebates increases as sales to certain wholesale and retail customers increase. However, since these rebate programs are not identical for all customers, the size of the reserve will depend on the mix of customers that are eligible to receive rebates.

Returns Consistent with industry practice, the Company has a product returns policy that allows customers to return product within a specified period prior to and subsequent to the product s lot expiration date in exchange for a credit to be applied to future purchases. The Company s policy requires that the customer obtain pre-approval from the Company for any qualifying return. The Company estimates its provision for returns based on historical experience, changes to business practices, and credit terms. While such experience has allowed for reasonable estimations in the past, history may not always be an accurate indicator of future returns. The Company continually monitors the provisions for returns and makes adjustments when management believes that actual product returns may differ from established reserves. Generally, the reserve for returns increases as net sales increase. The reserve for returns is included in the rebates, chargebacks and returns payable account on the balance sheet.

Table of Contents

Other Adjustments Other adjustments consist primarily of price adjustments, also known as shelf stock adjustments, which are credits issued to reflect decreases in the selling prices of the Company s products that customers have remaining in their inventories at the time of the price reduction. Decreases in selling prices are discretionary decisions made by management to reflect competitive market conditions. Amounts recorded for estimated shelf stock adjustments are based upon specified terms with direct customers, estimated declines in market prices, and estimates of inventory held by customers. The Company regularly monitors these and other factors and evaluates the reserve as additional information becomes available. Other adjustments are included in the rebates and chargebacks payable account on the balance sheet.

The following tables identify the reserves for each major category of revenue allowance and a summary of the activity for the three months ended September 30, 2009 and 2008:

For the three months ended September 30, 2009

Reserve Category	Chargebacks	Rebates	Returns	Other	Total
Reserve Balance as of June 30, 2009	$ 6,089,802	$ 2,537,746	$ 5,106,992	$	$ 13,734,540
Actual credits issued related to sales recorded in prior fiscal years	(4,767,581)	(1,852,708)	(1,147,720)		(7,768,009)
Reserves or (reversals) charged during Fiscal 2010 related to sales in prior fiscal years					
Reserves charged to net sales during Fiscal 2010 related to sales recorded in Fiscal 2010	10,272,936	4,066,855	1,140,128	407,784	15,887,703
Actual credits issued related to sales recorded in Fiscal 2010	(7,000,389)	(1,789,955)		(407,784)	(9,198,128)
Reserve Balance as of September 30, 2009	$ 4,594,768	$ 2,961,938	$ 5,099,400	$	$ 12,656,106

For the three months ended September 30, 2008

Reserve Category	Chargebacks	Rebates	Returns	Other	Total
Reserve Balance as of June 30, 2008	$ 4,049,407	$ 632,314	$ 13,642,589	$ 2,107	$ 18,326,417
Actual credits issued related to sales recorded in prior fiscal years	(2,865,229)	(255,126)	(6,425,413)		(9,545,768)
Reserves or (reversals) charged during Fiscal 2009 related to sales in prior fiscal years			2,107	(2,107)	
Reserves charged to net sales during Fiscal 2009 related to sales recorded in Fiscal 2009	9,144,349	2,949,913	1,142,474	42,957	13,279,693
Actual credits issued related to sales recorded in Fiscal 2009	(5,129,939)	(1,537,556)		(40,096)	(6,707,591)
Reserve Balance as of September 30, 2008	$ 5,198,588	$ 1,789,545	$ 8,361,757	$ 2,861	$ 15,352,751

The total reserve for chargebacks, rebates, returns and other adjustments decreased from $13,734,540 at June 30, 2009 to $12,656,106 at September 30, 2009. As of September 30, 2009 approximately $9,924,000 of the original $10,545,000 return reserve recorded in Fiscal 2008 for Prenatal Multivitamin was applied to accounts receivable for customers who had returned the Prenatal Multivitamin product by that date, leaving a balance of approximately $621,000 of Multivitamin returns reserve on the consolidated balance sheet at September 30, 2009. The decrease in chargeback reserves between June 30, 2009 and September 30, 2009 was due primarily to a decrease in inventory levels at wholesaler distribution centers.

Table of Contents

The Company ships its products to the warehouses of its wholesale and retail chain customers. When the Company and a customer enter into an agreement for the supply of a product, the customer will generally continue to purchase the product, stock its warehouse(s), and resell the product to its own customers. The Company s customer will reorder the product as its warehouse is depleted. The Company generally has no minimum size orders for its customers. Additionally, most warehousing customers prefer not to stock excess inventory levels due to the additional carrying costs and inefficiencies created by holding excess inventory. As such, the Company s customers continually reorder the Company s products. It is common for the Company s customers to order the same products on a monthly basis. For generic pharmaceutical manufacturers, it is critical to ensure that customers warehouses are adequately stocked with its products. This is important due to the fact that several generic competitors compete for the consumer demand for a given product. Availability of inventory ensures that a manufacturer s product is considered. Otherwise, retail prescriptions would be filled with competitors products. For this reason, the Company periodically offers incentives to its customers to purchase its products. These incentives are generally up-front discounts off its standard prices at the beginning of a generic campaign launch for a newly-approved or newly-introduced product, or when a customer purchases a Lannett product for the first time. Customers generally inform the Company that such purchases represent an estimate of expected resale for a period of time. This period of time is generally up to three months. The Company records this revenue, net of any discounts offered and accepted by its customers at the time of shipment. The Company s products have either 24 months or 36 months of shelf-life at the time of manufacture. The Company monitors its customers purchasing trends to attempt to identify any significant lapses in purchasing activity. If the Company observes a lack of recent activity, inquiries will be made to such customer regarding the success of the customer s resale efforts. The Company attempts to minimize any potential return (or shelf life issues) by maintaining an active dialogue with the customers.

The products that the Company sells are generic versions of brand named drugs. The consumer markets for such drugs are well-established markets with many years of historically-confirmed consumer demand. Such consumer demand may be affected by several factors, including alternative treatments and costs, etc. However, the effects of changes in such consumer demand for the Company s products, like generic products manufactured by other generic companies, are gradual in nature. Any overall decrease in consumer demand for generic products generally occurs over an extended period of time. This is because there are thousands of doctors, prescribers, third-party payers, institutional formularies and other buyers of drugs that must change prescribing habits and medicinal practices before such a decrease would affect a generic drug market. If the historical data the Company uses and the assumptions management makes to calculate its estimates of future returns, chargebacks, and other credits do not accurately approximate future activity, its net sales, gross profit, net income and earnings per share could change. However, management believes that these estimates are reasonable based upon historical experience and current conditions.

Cash and cash equivalents The Company considers all highly liquid securities purchased with original maturities of 90 days or less to be cash equivalents. Cash equivalents are stated at cost, which approximates market value, and consist of certificates of deposit that are readily converted to cash.

Accounts Receivable - The Company performs ongoing credit evaluations of its customers and adjusts credit limits based upon payment history and the customer s current credit worthiness, as determined by a review of current credit information. The Company continuously monitors collections and payments from its customers and maintains a provision for estimated credit losses based upon historical experience and any specific customer collection issues that have been identified. While such credit losses have historically been within both the Company s expectations and the provisions established, the Company cannot guarantee that it will continue to experience the same credit loss rates that it has in the past.

Fair Value of Financial Instruments - The Company s financial instruments consist primarily of cash and cash equivalents, accounts receivable, accounts payable, accrued expenses and debt obligations. The carrying values of these assets and liabilities approximate fair value based upon the short-term nature of these instruments. The

Table of Contents

Company has estimated that the fair value of long-term debt associated with the 20 year mortgage on its land and building in Cody, Wyoming approximates the discounted amount of future payments to the mortgage-holder.

Investment Securities - The Company s investment securities consist of marketable debt securities, primarily in U.S. government and agency obligations. All of the Company s marketable debt securities are classified as available-for-sale and recorded at fair value, based on quoted market prices. Unrealized holding gains and losses are recorded, net of any tax effect, as a separate component of accumulated other comprehensive income. No gains or losses on marketable debt securities are realized until they are sold or a decline in fair value is determined to be other-than-temporary. The Company reviews its marketable securities and determines whether the investments are other-than-temporarily impaired. If the investments are deemed to be other-than-temporarily impaired, the investments are written down to their then current fair market value with a new cost basis being established. There were no securities determined by management to be other-than-temporarily impaired during the three months ended September 30, 2009, or the fiscal year ended June 30, 2009.

Shipping and Handling Costs The cost of shipping products to customers is recognized at the time the products are shipped, and is included in cost of sales.

Research and Development Research and development expenses are charged to operations as incurred.

Intangible Assets In March 2004, the Company entered into an agreement with Jerome Stevens Pharmaceuticals, Inc. (JSP) for the exclusive marketing and distribution rights in the United States to the current line of JSP products in exchange for four million (4,000,000) shares of the Company s common stock. As a result of the JSP agreement, the Company recorded an intangible asset of $67,040,000 for the exclusive marketing and distribution rights obtained from JSP. The intangible asset was recorded based upon the fair value of the four million (4,000,000) shares at the time of issuance to JSP. During the quarter ended March 31, 2005, the Company recorded a non-cash impairment loss of approximately $46,093,000 to reduce the carrying value of the intangible asset to its fair value of approximately $16,062,000 as of the date of the impairment. As of September 30, 2009 and June 30, 2009, management concluded the carrying value of the intangible asset was less than its fair value and, therefore, no further impairment was required. The Company will incur annual amortization expense of approximately $1,785,000 for the JSP intangible asset over the remaining term of the agreement.

On April 10, 2007, the Company entered into a Stock Purchase Agreement to acquire Cody by purchasing all of the remaining shares of common stock of Cody. The consideration for the April 10, 2007 acquisition was approximately $4,438,000, which represented the fair value of the tangible net assets acquired. The agreement also required Lannett to issue to the sellers up to 120,000 shares of unregistered common stock of the Company contingent upon the receipt of a license from a regulatory agency. This license was subsequently received in July 2008 and triggered the payment of 105,000 shares (87.5% of the 120,000 shares as the Company already owned 12.5%) of Lannett stock to the former owners of Cody Labs, which was completed in October 2008. Therefore, the Company recorded an intangible asset related to the acquisition of a drug import license in the original amount of $581,175 and recorded a corresponding deferred tax liability of approximately $150,700 due to the non-deductibility of the amortization for tax purposes. The Company has assigned a 15 year life to this intangible asset based on average life cycles of Lannett products.

In January 2005, Lannett Holdings, Inc. entered into an agreement in which the Company purchased for $100,000 and future royalty payments the proprietary rights to manufacture and distribute a product for which Pharmeral, Inc. owned the ANDA. In May 2008, the Company and Pharmeral waived their rights to any royalty payments on the sales of the drug by Lannett, under Lannett s current ownership structure. Should Lannett undergo a change in control transaction with a third party, this royalty will be reinstated. In Fiscal 2008, the Company obtained FDA

approval to use these proprietary rights. Accordingly, the Company originally capitalized these purchased product rights as an indefinite lived intangible asset and tested this asset for impairment at least on an annual basis. During the fourth quarter of fiscal 2009, it was determined that this intangible asset no longer has an indefinite life. No impairment

Table of Contents

existed because the estimated fair value exceeded the carrying amount on that date. Accordingly, the $100,000 carrying amount of this intangible asset is being amortized on a straight line basis prospectively over its 10 year remaining estimated useful life.

In August 2009, the Company acquired eight new ANDAs covering three separate product lines from another generic drug manufacturer for a purchase price of $500,000. It is expected that the Company will be able to produce these products by the third quarter of this fiscal year. The Company has assigned a 15 year life to this intangible asset based on average life cycles of Lannett products. Amortization will begin when the Company starts shipping these products.

For the three months ended September 30, 2009 and 2008, the Company incurred amortization expense of approximately $458,000 and $446,000, respectively. As of September 30, 2009 and June 30, 2009, accumulated amortization totaled approximately $8,083,000 and $7,624,000, respectively.

Future annual amortization expense consists of the following as of September 30, 2009:

Fiscal Year Ending June 30,		Annual Amortization Expense
2010	$	1,375,059
2011		1,833,412
2012		1,833,412
2013		1,833,412
2014		1,387,245
Thereafter		397,817
	$	8,660,357

The amounts above do not include the ANDA s purchased in August 2009 for $500,000 as amortization will begin when the Company starts shipping these products.

Advertising Costs - The Company charges advertising costs to operations as incurred. Advertising expense for the three months ended September 30, 2009 and 2008 was approximately $10,000 and $13,000, respectively.

Income Taxes - The Company uses the liability method to account for income taxes. Deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities as measured by the enacted tax rates which will be in effect when these differences reverse. Deferred tax expense/(benefit) is the result of changes in deferred tax assets and liabilities. The Company may recognize the tax benefit from an uncertain tax position claimed on a tax return only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. The authoritative standards issued by the FASB also provide guidance on de-recognition, classification, interest and penalties on income taxes, accounting in interim periods and requires increased disclosures.

Segment Information - The Company operates one business segment - generic pharmaceuticals; accordingly the Company has one reporting segment. The Company aggregates its financial information for all products and reports as one operating segment. The following table identifies the Company s approximate net product sales by medical indication for the three months ended September 30, 2009 and 2008:

Table of Contents

Medical Indication	For the Three Months Ended September 30, 2009	2008
Migraine Headache	$ 2,663,000	$ 2,319,000
Epilepsy	611,000	680,000
Prescription Vitamin	1,489,000	
Heart Failure	4,852,000	6,348,000
Thyroid Deficiency	13,024,000	11,466,000
Antibiotic	1,661,000	1,496,000
Pain Management	2,880,000	276,000
Other	4,255,000	2,983,000
Total	$ 31,435,000	$ 25,568,000

Concentration of Market and Credit Risk - Five of the Company s products, defined as generics containing the same active ingredient or combination of ingredients, accounted for approximately 41%, 15%, 9%, 8% and 5%, respectively of net sales for the three months ended September 30, 2009. Those same products accounted for 45%, 25%, 1%, 9% and 0% respectively, of net sales for the three months ended September 30, 2008.

Four of the Company s customers accounted for 26%, 14%, 9%, and 8%, respectively, of net sales for the three months ended September 30, 2009, and 29%, 5%, 3%, and 8%, respectively, of net sales for the three months ended September 30, 2008. At September 30, 2009, these four customers accounted for 60% of the Company s accounts receivable balances. At June 30, 2009, these four customers accounted for 54% of the Company s accounts receivable balances.

Share-based Compensation - The Company recognizes compensation cost for share-based compensation issued to or purchased by employees, net of estimated forfeitures, under share-based compensation plans using a fair value method.

At September 30, 2009, the Company had three stock-based employee compensation plans (the Old Plan, the 2003 Plan, and the Long-term Incentive Plan, or LTIP).

During the three months ended September 30, 2008, the Company awarded 30,000 shares of restricted stock under the LTIP which vested immediately. Stock compensation expense of $101,400 was recognized during the three months ended September 30, 2008, related to these shares of restricted stock.

During the fiscal year ended June 30, 2008, the Company awarded 209,264 shares of restricted stock under the LTIP of which, 74,464 of these shares vested 100% on January 1, 2008. The remainder vests in equal portions on September 18, 2008, 2009 and 2010. Stock compensation expense of $43,007 and $43,007 was recognized during the three months ended September 30, 2009 and 2008, respectively, related to the vesting of these shares of restricted stock.

The Company measures the fair value of share-based compensation cost for options using the Black-Scholes option pricing model. The following table presents the weighted average assumptions used to estimate fair values of the stock options granted and the estimated forfeiture rates during the three months ended September 30:

Table of Contents

	Incentive Stock Options FY 2010	Non-qualified Stock Options FY 2010	Incentive Stock Options FY 2009	Non-qualified Stock Options FY 2009
Risk-free interest rate	2.4%	%	2.5%	2.5%
Expected volatility	67.1%	%	56.5%	56.5%
Expected dividend yield	0.0%	%	0.0%	0.0%
Forfeiture rate	5.0%	%	5.0%	5.0%
Expected term	5.0 years	n/a	5.0 years	5.0 years
Weighted average fair value at date of grant	$ 4.86	$	$ 1.41	$ 1.41

There were no options issued under the LTIP during the three months ended September 30, 2009. Approximately 100,000 options were issued under the LTIP during the three months ended September 30, 2008. There were 36,100 and zero shares under option that were exercised in the three months ended September 30, 2009 and 2008, respectively. At September 30, 2009, there were 1,563,181 options outstanding. Of those, 571,800 were options issued under the LTIP, 780,148 were issued under the 2003 Plan, and 211,233 under the Old Plan. There are no further shares authorized to be issued under the Old Plan. 1,125,000 shares were authorized to be issued under the 2003 Plan, with 20,490 shares under option having already been exercised under that plan. 2,500,000 shares were authorized to be issued under the LTIP, with 34,100 shares under option having already been exercised under that plan.

Expected volatility is based on the historical volatility of the price of our common shares since the date we commenced trading on the NYSE-Amex, April 2002, or a historical period equal to the expected term of the option, whichever is shorter. We use historical information to estimate expected term within the valuation model. The expected term of awards represents the period of time that options granted are expected to be outstanding. The risk-free rate for periods within the expected life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. Compensation cost is recognized using the straight-line method over the vesting or service period and is net of estimated forfeitures.

The forfeiture rate assumption is the estimated annual rate at which unvested awards are expected to be forfeited during the vesting period. This assumption is based on our historical forfeiture rate. Periodically, management will assess whether it is necessary to adjust the estimated rate to reflect changes in actual forfeitures or changes in expectations. For example, adjustments may be needed if forfeitures were affected by turnover that resulted from a business restructuring that is not expected to recur. The Company will incur additional expense if the actual forfeiture rate is lower than originally estimated. A recovery of prior expense will be recorded if the actual rate is higher than originally estimated.

The following table presents all share-based compensation costs recognized in our statements of operations, substantially all of which is reflected in the selling, general and administrative expense line:

	Three Months Ended September 30,	
	2009	2008
Share based compensation		
Stock options	$ 232,868	$ 218,799
Employee stock purchase plan	21,440	26,591
Restricted stock	43,007	144,407
Tax benefit at effective rate	27,604	22,180

Options outstanding that have vested and are expected to vest as of September 30, 2009 are as follows:

Table of Contents

	Awards		Weighted - Average Exercise Price		Aggregate Intrinsic Value	Weighted Average Remaining Contractual Life
Options vested	1,149,641	$	8.73	$	1,575,149	5.7
Options expected to vest	392,863	$	4.62	$	1,143,046	8.5
Total vested and expected to vest	1,542,504	$	7.68	$	2,718,195	6.4

A summary of nonvested restricted stock award activity as of September 30, 2009 and changes during the three months then ended, is presented below:

	Awards		Weighted Average Grant Date Fair Value
Nonvested at July 1, 2009	77,198	$	311,108
Granted			
Vested	(25,500)		(102,765)
Forfeited	(6,200)		(24,986)
Nonvested at September 30, 2009	45,498	$	183,357

Table of Contents

A summary of award activity under the Plans as of September 30, 2009 and 2008, and changes during the three months then ended, is presented below:

	Incentive Stock Options				Nonqualified Stock Options			
	Awards	Weighted-Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Life	Awards	Weighted-Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Life
Outstanding at July 1, 2009	958,909	$ 5.60			626,772	$ 10.52		
Granted	20,000	$ 8.48				$		
Exercised	(36,100)	$ 4.23						
Forfeited, expired or repurchased	(6,400)	$ 5.38				$		
Outstanding at September 30, 2009	936,409	$ 5.71	$ 2,217,739	7.2	626,772	$ 10.52	$ 551,242	5.3
Outstanding at September 30, 2009 and not yet vested	350,474	$ 4.64	$ 1,015,723	8.6	63,067	$ 4.51	$ 187,483	8.1
Exercisable at September 30, 2009	585,935	$ 6.36	$ 1,202,016	6.3	563,705	$ 11.19	$ 373,133	4.9

	Incentive Stock Options				Nonqualified Stock Options			
	Awards	Weighted-Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Life	Awards	Weighted-Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Life
Outstanding at July 1, 2008	991,267	$ 5.76			703,064	$ 10.16		
Granted	62,002	$ 2.80			37,998	$ 2.80		
Exercised								
Forfeited or expired	(42,000)	$ 4.89			(25,000)	$ 5.02		
Outstanding at September 30, 2008	1,011,269	$ 5.62	$ 3,000	7.9	716,062	$ 9.95		6.4
Outstanding at September 30, 2008 and not yet vested	521,180	$ 4.45		8.9	163,288	$ 4.75		8.8
Exercisable at September 30, 2008	490,089	$ 6.86	$ 3,000	6.8	552,774	$ 11.48		5.7

Options with a fair value of $421,281 vested during the three months ended September 30, 2009. As of September 30, 2009, there was $946,124 of total unrecognized compensation cost related to nonvested share-based compensation awards granted under the Plans. That cost is expected to be recognized over a weighted average period of 1.4 years. As of September 30, 2008, there was approximately $1,663,000 of total unrecognized compensation cost related to nonvested share-based compensation awards granted under the Plans. The Company issues new shares when stock options are exercised.

Unearned Grant Funds The Company records all grant funds received as a liability until the Company fulfills all the requirements of the grant funding program.

Table of Contents

Earnings per Common Share A dual presentation of basic and diluted earnings per share is required on the face of the Company s consolidated statement of operations as well as a reconciliation of the computation of basic earnings per share to diluted earnings per share. Basic earnings per share excludes the dilutive impact of common stock equivalents and is computed by dividing net income by the weighted-average number of shares of common stock outstanding for the period. Diluted earnings per share include the effect of potential dilution from the exercise of outstanding common stock equivalents into common stock using the treasury stock method. A reconciliation of the Company s basic and diluted income per share follows:

	2009		2008	
	Net Income (Numerator)	**Shares (Denominator)**	**Net Loss (Numerator)**	**Shares (Denominator)**
Basic earnings per share factors	$ 2,857,370	24,533,562	$ 1,226,165	24,306,488
Effect of potentially dilutive option and restricted stock plans		521,099		76,463
Diluted earnings per share factors	$ 2,857,370	25,054,661	$ 1,226,165	24,382,951
Basic earnings per share	$ 0.12		$ 0.05	
Diluted earnings per share	$ 0.11		$ 0.05	

The number of anti-dilutive shares that have been excluded in the computation of diluted earnings per share for the three months ended September 30, 2009 and 2008 were 352,845 and 1,807,529, respectively.

Note 3. New Accounting Standards

In June 2009, the Financial Accounting Standards Board (FASB) issued the FASB Accounting Standards Codification (the Codification), which establishes the Codification as the source of authoritative accounting guidance to be applied in the preparation of financial statements in conformity with generally accepted accounting principles (GAAP). The Codification, which changes the referencing of financial standards, became effective for interim and annual periods ending on or after September 15, 2009. The Codification is now the single official source of authoritative U.S. GAAP (other than guidance issued by the Securities and Exchange Commission), superseding existing FASB, American Institute of Certified Public Accountants, Emerging Issues Task Force and related literature. Only one level of authoritative U.S. GAAP now exists. All other literature is considered non-authoritative. The Codification does not change U.S. GAAP. We adopted the Codification during the first quarter of fiscal year 2010.

In December 2007, the FASB issued authoritative guidance which significantly changes the accounting for business combinations in a number of areas including the treatment of contingent consideration, contingencies, acquisition costs, in-process research and development and restructuring costs. In addition, under the guidance, changes in deferred tax asset valuation allowances and acquired income tax uncertainties in a business combination after the measurement period will impact income tax expense. In April 2009, updated guidance was issued to address application issues regarding the accounting and disclosure provisions for contingencies. The authoritative guidance applies prospectively to business combinations for which the acquisition date is on or after the beginning of the fiscal year beginning July 1, 2009. Early application is not permitted. The effect of this authoritative guidance on our consolidated financial statements will depend on the nature and terms of any business combinations that occur after the effective date.

15

Table of Contents

In December 2007, the FASB issued authoritative guidance to establish accounting and reporting standards for the noncontrolling (minority) interest in a subsidiary and for the deconsolidation of a subsidiary. It clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements and establishes a single method of accounting for changes in a parent s ownership interest in a subsidiary that do not result in deconsolidation. We adopted this authoritative guidance effective July 1, 2009. As a result of the adoption, the Company presents noncontrolling interests as a component of equity on its consolidated balance sheets. Minority interest expense is now shown below net income under the heading net income from noncontrolling interest . Prior year financial statements have been reclassified to reflect the adoption of this guidance. The adoption of this guidance did not have any other significant impact on our consolidated financial statements.

In April 2008, the FASB issued authoritative guidance which amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset. The guidance is intended to improve the consistency between the useful life of a recognized intangible asset and the period of expected cash flows used to measure the fair value of the asset. We adopted this authoritative guidance effective July 1, 2009. The adoption of this guidance did not have a significant impact on our consolidated financial statements.

In June 2009, the FASB issued authoritative guidance for determining whether an entity is a variable interest entity and modifies the methods allowed for determining the primary beneficiary of a variable interest entity. This guidance requires an enterprise to perform an analysis to determine whether the enterprise s variable interest or interests give it a controlling financial interest in a variable interest entity. It also requires ongoing reassessments of whether an enterprise is the primary beneficiary of a variable interest entity. The authoritative guidance is effective for the annual reporting period that begins after November 15, 2009. We do not expect the adoption of this authoritative guidance to have a significant impact on our consolidated financial statements.

Note 4. Inventories

The Company values its inventory at the lower of cost (determined by the first-in, first-out method) or market, regularly reviews inventory quantities on hand, and records a provision for excess and obsolete inventory based primarily on estimated forecasts of product demand. The Company s estimates of future product demand may fluctuate, in which case estimated required reserves for excess and obsolete inventory may increase or decrease. If the Company s inventory is determined to be overvalued, the Company recognizes such costs in cost of goods sold at the time of such determination. Likewise, if inventory is determined to be undervalued, the Company may have recognized excess cost of goods sold in previous periods and would recognize such additional operating income at the time of sale.

Inventories consist of the following:

	September 30, 2009	June 30, 2009
Raw materials	$ 5,023,930	$ 5,755,982
Work-in-process	3,328,786	2,846,600
Finished goods	7,688,876	6,664,193
Packaging supplies	968,632	928,586
	$ 17,010,224	$ 16,195,361

16

Table of Contents

The preceding amounts are net of inventory reserves of $2,792,384 and $2,744,305 at September 30, 2009 and June 30, 2009, respectively.

Note 5. Property, Plant and Equipment

Property, plant and equipment are stated at cost. Depreciation is provided for by the straight-line method for financial reporting purposes over the estimated useful lives of the assets. Depreciation expense for the three months ended September 30, 2009 and 2008 was approximately $708,000 and $837,000, respectively.

Property, plant and equipment consist of the following:

	Useful Lives	September 30, 2009	June 30, 2009
Land		$ 918,314	$ 918,314
Building and improvements	10 - 39 years	17,084,701	17,048,351
Machinery and equipment	5 - 10 years	22,871,684	22,573,324
Furniture and fixtures	5 - 7 years	896,871	891,169
		41,771,570	41,431,158
Accumulated depreciation		(19,242,024)	(18,533,773)
		$ 22,529,546	$ 22,897,385

Note 6. Investment Securities - Available-for-Sale

On July 1, 2008, the Company adopted the authoritative guidance which clarifies the definition of fair value, establishes a framework for measuring fair value, and expands the disclosures on fair value measurements. Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The authoritative guidance 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. Three levels of inputs were established that may be used to measure fair value:

Level 1 Quoted prices in active markets for identical assets or liabilities. The Company does not have any level 1 available-for-sale securities as of September 30, 2009 or June 30, 2009.

Level 2 Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices for identical or similar instruments in markets that are not active; or model-derived valuations whose inputs are observable or whose significant value drivers are observable. The Company s Level 2 assets and liabilities primarily include debt securities with quoted prices that are traded less frequently than exchange-traded instruments, corporate bonds, U.S. government and agency securities and certain mortgage-backed and asset-backed securities whose values are determined using pricing models with inputs that are observable in the market or can be derived principally from or corroborated by observable market data. The fair value of the Company s available-for-sale securities in the table below are derived solely from level 2 inputs.

Level 3 Unobservable inputs that are supported by little or no market activity and that are financial instruments whose values are determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant judgment or estimation. The Company does not have any level 3 available-for-sale securities as of September 30, 2009 or June 30, 2009.

Table of Contents

If the inputs used to measure the financial assets and liabilities fall within more than one level described above, the categorization is based on the lowest level input that is significant to the fair value measurement of the instrument.

The amortized cost, gross unrealized gains and losses, and fair value of the Company s available-for-sale securities are summarized as follows:

September 30, 2009

Available-for-Sale

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Government Agency	$ 928,910	$ 35,035	$	$ 963,945
Corporate Bonds	179,507	2,466		181,973
	$ 1,108,417	$ 37,501	$	$ 1,145,918

June 30, 2009

Available-for-Sale

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Government Agency	$ 928,910	$ 40,352	$	$ 969,262
Asset-Backed Securities	179,507	900		180,407
	$ 1,108,417	$ 41,252	$	$ 1,149,669

The amortized cost and fair value of the Company s current available-for-sale securities by contractual maturity at September 30, 2009 and June 30, 2009 are summarized as follows:

	September 30, 2009 Available for Sale		June 30, 2009 Available for Sale	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	$ 720,238	$ 747,448	$ 338,159	$ 347,921
Due after one year through five years	388,179	398,470	770,258	801,748
Due after five years through ten years				
Due after ten years				
Total available-for-sale securities	1,108,417	1,145,918	1,108,417	1,149,669

Less current portion	720,238	747,448	338,159	347,921
Long term available-for-sale securites	$ 388,179	$ 398,470	$ 770,258	$ 801,748

18

Table of Contents

The Company uses the specific identification method to determine the cost of securities sold. For the three months ended September 30, 2009, the Company had no realized gains or losses, whereas for the three months ended September 30, 2008, the Company had realized losses of $4,931.

As of September 30 and June 30, 2009, there were no securities held from a single issuer that represented more than 10% of shareholders equity. As of September 30, 2009, there were no individual securities in a continuous unrealized loss position.

Note 7. Bank Line of Credit

The Company has a $3,000,000 line of credit from Wachovia Bank, N.A. (Wachovia) that bears interest at the prime interest rate less 0.25% (2.75% and 3.00% at September 30 and June 30, 2009, respectively). As of September 30 and June 30, 2009, the Company had $3,000,000 of availability under this line of credit. The line of credit is collateralized by substantially all of the Company s assets. The agreement contains covenants with respect to working capital, net worth and certain ratios, as well as other covenants. As of September 30, 2009, the Company was in compliance with all financial covenants under the agreement.

The Company is required to maintain and comply with a debt service coverage ratio of not less than 2 to 1 (to be measured annually). Debt service coverage is defined as the ratio of earnings before interest, taxes, depreciation and amortization (EBITDA) to the sum of interest expenses plus scheduled current maturities of long-term debt and current capitalized lease obligations. Previously, the terms of the existing agreement required the Company to at all times maintain deposit balances in excess of $3,500,000 with Wachovia Bank for the balance of the arrangement. Additionally, the Company was required to pay Wachovia an availability fee equal to 0.50% per annum calculated daily, on the available but unused balance of the line of credit.

The existing line of credit, which was scheduled to expire on November 30, 2009, was renewed and extended during the first quarter of Fiscal 2010 to November 30, 2010. As part of the renewal agreement, the Company is no longer required to maintain any minimum deposit balances with Wachovia, and the availability fee on the unused balance of the line of credit was reduced to 0.375%.

Note 8. Unearned Grant Funds

In July 2004, the Company received $500,000 of grant funding from the Commonwealth of Pennsylvania, acting through the Department of Community and Economic Development. The grant funding program requires the Company to use the funds for machinery and equipment located at their Pennsylvania locations, hire an additional 100 full-time employees by June 30, 2006, operate its Pennsylvania locations a minimum of five years and meet certain matching investment requirements. If the Company fails to comply with any of the requirements above, the Company would be liable to repay the full amount of the grant funding ($500,000). The Company has recorded the unearned grant funds as a liability until the Company complies with all of the requirements of the grant funding program As of September 30, 2009, the Company has had preliminary discussions with the Commonwealth of Pennsylvania to determine whether it will be required to repay any of the funds provided under the grant funding program. Based on information available at September 30, 2009, the Company has recorded the grant funding as a long-term liability under the caption of Unearned Grant Funds.

19

Table of Contents

Note 9. Long-Term Debt

Long-term debt consists of the following:

	September 30, 2009	June 30, 2009
PIDC Regional Center, LP III loan	$ 4,500,000	$ 4,500,000
Pennsylvania Industrial Development Authority loan	984,007	1,002,607
Pennsylvania Department of Community & Economic Development loan	157,243	182,831
Tax-exempt bond loan (PAID)	680,000	680,000
Equipment loan		80,130
First National Bank of Cody mortgage	1,681,233	1,693,200
Total debt	8,002,483	8,138,768
Less current portion	357,806	435,386
Long term debt	$ 7,644,677	$ 7,703,382

	September 30, 2009	June 30, 2009
Current Portion of Long Term Debt		
PIDC Regional Center, LP III loan	$	$
Pennsylvania Industrial Development Authority loan	75,580	75,017
Pennsylvania Department of Community & Economic Development loan	104,130	103,100
Tax-exempt bond loan (PAID)	125,000	125,000
Equipment loan		80,130
First National Bank of Cody mortgage	53,096	52,139
Total current portion of long term debt	$ 357,806	$ 435,386

The Company financed $4,500,000 through the Philadelphia Industrial Development Corporation (PIDC). The Company pays a bi-annual interest payment at a rate equal to two and one-half percent per annum. The outstanding principal balance is due and payable on January 1, 2011.

The Company financed $1,250,000 through the Pennsylvania Industrial Development Authority (PIDA). The Company is required to make equal payments each month for 180 months starting February 1, 2006 with interest of two and three-quarter percent per annum.

An additional $500,000 was financed through the Pennsylvania Department of Community and Economic Development Machinery and Equipment Loan Fund. The Company is required to make equal payments for 60 months starting May 1, 2006 with interest of two and three quarter percent per annum.

In April 1999, the Company entered into a loan agreement (the Agreement) with a governmental authority, the Philadelphia Authority for Industrial Development (the Authority or PAID), to finance future construction and growth projects of the Company. The Authority issued $3,700,000 in tax-exempt variable rate demand and fixed rate revenue bonds to provide the funds to finance such growth projects pursuant to a trust indenture (the Trust Indenture). A portion of the Company s proceeds from the bonds was used to pay for bond issuance costs of approximately $170,000. The Trust Indenture requires that the Company repay the Authority loan through installment payments beginning in May 2003 and continuing through May 2014, the year the bonds mature. The

Table of Contents

bonds bear interest at the floating variable rate determined by the organization responsible for selling the bonds (the remarketing agent). The interest rate fluctuates on a weekly basis. The effective interest rate at September 30, 2009 and June 30, 2009 was 0.69% and 0.62%, respectively.

The Company entered into agreements (the 2003 Loan Financing) with Wachovia to finance the purchase of the Torresdale Avenue facility, the renovation and setup of the building, and other anticipated capital expenditures. The Company, as part of the 2003 Loan Financing agreement, is required to make equal payments of principal and interest. The only portion of the loan that remained outstanding at June 30, 2009 was the Equipment Loan, which had an outstanding balance of $80,130 at June 30, 2009. This loan was fully repaid as of September 30, 2009.

The Company is required to maintain and comply with a debt service coverage ratio of not less than 2 to 1 (to be measured annually). Debt service coverage is defined as the ratio of earnings before interest, taxes, depreciation and amortization (EBITDA) to the sum of interest expenses plus scheduled current maturities of long-term debt and current capitalized lease obligations. Previously, the terms of the existing agreement required the Company to at all times maintain deposit balances in excess of $3,500,000 with Wachovia Bank for the balance of the arrangement. Additionally, the Company was required to pay Wachovia an availability fee equal to 0.50% per annum calculated daily, on the available but unused balance of the line of credit.

The existing line of credit, which was scheduled to expire on November 30, 2009, was renewed and extended during the first quarter of Fiscal 2010 to November 30, 2010. As part of the renewal agreement, the Company is no longer required to maintain any minimum deposit balances with Wachovia, and the availability fee on the unused balance of the line of credit was reduced to 0.375%.

The Company has executed Security Agreements with Wachovia, PIDA and PIDC in which the Company has agreed to pledge substantially all of its assets to collateralize the amounts due.

As part of the Cody acquisition, the Company became primary beneficiary to a variable interest entity (VIE) called Cody LCI Realty, LLC. See Note 16, Consolidation of Variable Interest Entity for additional description. The VIE owns land and a building which is being leased to Cody. A mortgage loan with First National Bank of Cody has been consolidated in the Company s financial statements, along with the related land and building. Principal and interest payments of $14,782, at a fixed interest rate of 7.5%, are being made on a monthly basis through June 2026. The mortgage loan is collateralized by the land and building.

Long-term debt amounts due, for the twelve month periods ended September 30 are as follows:

Twelve Month Periods	Amounts Payable to Institutions
2010	$ 357,806
2011	4,818,102
2012	274,802
2013	283,934
2014	279,293

Thereafter		1,988,546
	$	8,002,483

21

Table of Contents

Note 10. Contingencies

In early June 2008, the Company filed a declaratory judgment suit in the Federal District Court of Delaware (Civil Action No. 08-338 (JJF)) against KV Pharmaceuticals, DrugTech Corp., and Ther-Rx Corp (collectively KV). The complaint sought declaratory judgment for non-infringement and invalidity of certain patents owned by KV. The complaint further sought declaratory judgment of anti-trust violations and federal and state unfair competition violations for actions taken by KV in securing and enforcing these patents. After the complaint was filed, KV countered with a motion for a Temporary Restraining Order (TRO) to prevent the Company from launching its Multivitamin with Mineral Capsules (MMCs), due to alleged patent and trademark infringement issues. The TRO was heard and, ultimately, resulted in a conclusion by the court that the Company s product label on the MMCs should be modified. KV also countered with claims of infringement by the Company of KV s patents seeking the Company s profits for sales of MMCs or other monetary relief, preliminary and permanent injunctive relief, attorney s fees and a finding of willful infringement. On March 17, 2009 the Company and KV settled the litigation. In light of the withdrawal of KV s innovator prenatal product, and the resulting anticipated decline in sales and declining market for written prescription, the Company decided it was pointless to continue the litigation and entered into the settlement arrangement with KV. Pursuant to the settlement, the Company will receive a license from KV and will become an authorized generic provider. During the terms of the license, the Company will pay KV a royalty on all future sales of its Prenatal vitamin product. Lannett will cease offering its Prenatal vitamin product if and when the brand is restored to the marketplace.

In or about July 2008, Albion International and Albion, Inc. filed suit in the United States District Court, District of Utah (Case No. 2:08cv00515) against Lannett asserting claims for patent and trademark infringement, as well as unfair competition, arising out of Lannett s use of product that it purchased from Albion and used as an ingredient in its MMC. Lannett filed a motion to dismiss the complaint on the basis that it purchased the product from Albion and, as such, was authorized to use the product in its MMC. The Court granted the motion and dismissed the complaint but gave Albion leave to file an amended complaint. On January 20, 2009, Albion filed an amended complaint. Lannett filed an answer to the complaint and counterclaim, asserting, among other things, that Albion tortuously interfered with Lannett s contracts. Subsequent to the filing of the answer and counterclaim, Lannett and Albion reached an agreement in principal to settle the case. Under terms of the settlement, the parties would each dismiss their claims against each other and provide releases. On July 6, 2009, the settlement agreement was signed and on July 13, 2009 the case was dismissed.

Note 11. Commitments

Leases

In June 2006, Lannett signed a lease agreement on a 66,000 square foot facility located on seven acres in Philadelphia. The Company purchased this building in October 2009 for approximately $3.8 million plus the cost of fit out. A significant portion of the purchase price and fit out costs are expected to be financed through a series of loans with a bank and a Pennsylvania state run development agency by the third quarter of Fiscal 2010. This new facility is initially going to be used for warehouse space with the expectation of making this facility the Company s headquarters and possibly additional manufacturing space. The other Philadelphia locations will continue to be utilized for manufacturing, packaging, and research.

Lannett s subsidiary, Cody leases a 73,000 square foot facility in Cody, Wyoming. This location houses Cody s manufacturing and production facilities. Cody leases the facility from Cody LCI Realty, LLC, a Wyoming limited liability company which is 50% owned by Lannett. See Note 16.

Rental and lease expense for the three months ended September 30, 2009 and 2008 was approximately $82,000 and $110,000, respectively.

22

Table of Contents

Employment Agreements

The Company has entered into employment agreements with Arthur P. Bedrosian, President and Chief Executive Officer, Keith R. Ruck, Vice President of Finance and Chief Financial Officer, Kevin Smith, Vice President of Sales and Marketing, William Schreck, Senior Vice President and General Manager, Ernest Sabo, Vice President of Regulatory Affairs and Chief Compliance Officer, and Stephen Kovary, Vice President of Operations. Each of the agreements provide for an annual base salary and eligibility to receive a bonus. The bonus amounts of these executives are determined by the Board of Directors. Additionally, these executives are eligible to receive stock options and restricted stock awards, which are granted at the discretion of the Board of Directors, and in accordance with the Company s policies regarding stock option and restricted stock grants. Under the agreements, these executive employees may be terminated at any time with or without cause, or by reason of death or disability. In certain termination situations, the Company is liable to pay severance compensation to these executives of between 18 months and three years.

During the third quarter of Fiscal Year 2009, the Company s former Vice President of Finance, Treasurer, Secretary and Chief Financial Officer resigned. As part of his separation agreement, the Company is obligated to pay to him approximately $670,000 to settle any outstanding obligations from his employment agreement, including any salary, bonus, vacation, stock options and medical benefits. Of this amount, $300,440 was paid in Fiscal 2009 with $165,000 designated for the payment of pro rated bonus, and $11,440 was designated for the payment of accrued but unused paid time off. As part of the settlement, $124,000 was designated as the portion of the settlement related to the repurchase of his outstanding stock options. The Company therefore charged this amount to Additional Paid in Capital, as it represents the fair value of the options repurchased on the repurchase date. Additional payments totaling approximately $369,000 for severance and benefits will be paid in Fiscal 2010 and Fiscal 2011 pursuant to the separation agreement.

Note 12. Comprehensive Income

The Company s other comprehensive income (loss) is comprised of unrealized gains (losses) on investment securities classified as available-for-sale. The components of comprehensive income and related taxes consisted of the following as of September 30, 2009 and 2008:

	For the Three Months Ended September 30,	
	2009	**2008**
Other Comprehensive Income (Loss):		
Net Income	$ 2,857,370	$ 1,226,165
Unrealized Holding (Loss) Gain on Securities	(3,751)	7,793
Add: Tax savings at statutory rate	1,500	(3,117)
Total Other Comprehensive (Loss) Income	(2,251)	4,676
Total Comprehensive Income	$ 2,855,119	$ 1,230,841

Table of Contents

Note 13. Employee Benefit Plan

The Company has a defined contribution 401k plan (the Plan) covering substantially all employees. Pursuant to the Plan provisions, the Company is required to make matching contributions equal to 50% of each employee s contribution, but not to exceed 4% of the employee s compensation for the Plan year. Contributions to the Plan during the three months ended September 30, 2009 and 2008 were $153,000 and $88,000, respectively.

Note 14. Employee Stock Purchase Plan

In February 2003, the Company s shareholders approved an Employee Stock Purchase Plan (ESPP). Employees eligible to participate in the ESPP may purchase shares of the Company s stock at 85% of the lower of the fair market value of the common stock on the first day of the calendar quarter, or the last day of the calendar quarter. Under the ESPP, employees can authorize the Company to withhold up to 10% of their compensation during any quarterly offering period, subject to certain limitations. The ESPP was implemented on April 1, 2003 and is qualified under Section 423 of the Internal Revenue Code. The Board of Directors authorized an aggregate total of 1,125,000 shares of the Company s common stock for issuance under the ESPP. As of September 30, 2009, 183,576 shares have been issued under the ESPP. Compensation expense of $21,440 and $26,591 has been recognized for the three months ended September 30, 2009 and 2008, respectively, relating to the ESPP.

Note 15. Income Taxes

The Company uses the liability method to account for income taxes. Deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities as measured by the enacted tax rates which will be in effect when these differences reverse. Deferred tax expense/(benefit) is the result of changes in deferred tax assets and liabilities.

The provision for federal, state and local income taxes for the three months ended September 30, 2009 and 2008 was tax expense of approximately $1,828,000 and $920,000, respectively, with effective tax rates of 39% and 43%, respectively. The effective tax rate for the three months ended September 30, 2009 was a lower effective tax rate compared to September 30, 2008 due primarily to a change in the Federal rate from the 35% statutory rate to an estimated 34% actual rate, apportionment of income to Wyoming which has no state income tax, and federal income tax credits.

The Company may recognize the tax benefit from an uncertain tax position claimed on a tax return only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. The authoritative standards issued by the FASB also provide guidance on de-recognition, classification, interest and penalties on income taxes, accounting in interim periods and requires increased disclosures.

As of September 30, 2009 and June 30, 2009, the Company reported total unrecognized benefits of $297,663, all of which would affect the Company s effective tax rate if recognized. As a result of the positions taken during the period, the Company has not recorded any interest and penalties for the period ended September 30, 2009 in the statement of operations and no cumulative interest and penalties have been recorded either in the Company s statement of financial position as of September 30, 2009 and June 30, 2009. The Company will recognize interest accrued on unrecognized tax benefits in interest expense and any related penalties in operating expenses. The Company does not believe that the total unrecognized tax benefits will significantly increase or decrease in the next twelve months.

The Company files tax returns in the United States federal jurisdiction, Pennsylvania, New Jersey and California. The Company s tax returns for Fiscal 2005 and prior generally are no longer subject to review as such years generally are closed. The Company has been notified that its federal income tax return for Fiscal 2008 will be reviewed by the IRS during Fiscal 2010. The Company believes that an unfavorable resolution for open tax years would not be material to the financial position of the Company.

Table of Contents

Note 16. Consolidation of Variable Interest Entity

Lannett consolidates any Variable Interest Entity (VIE) of which it is the primary beneficiary. The liabilities recognized as a result of consolidating a VIE do not represent additional claims on our general assets; rather, they represent claims against the specific assets of the consolidated VIE. Conversely, assets recognized as a result of consolidating a VIE do not represent additional assets that could be used to satisfy claims against our general assets. Reflected in the September 30, 2009 and June 30, 2009 balance sheets are consolidated VIE assets of approximately $1.9 million and $1.9 million, which are comprised mainly of land and building. VIE liabilities consist of a mortgage on that property in the amount of approximately $1.7 and $1.7 million at September 30, 2009 and June 30, 2009, respectively.

Cody LCI Realty LLC (Realty) is the only VIE that is consolidated. Realty has been consolidated by Cody prior to its acquisition by Lannett. Realty is a 50/50 joint venture with a former shareholder of Cody. Its purpose was to acquire the facility used by Cody. Until the acquisition of Cody in April 2007, Lannett had not consolidated the VIE because Cody Labs had been the primary beneficiary of the VIE. The risks associated with our interests in this VIE is limited to a decline in the value of the land and building as compared to the balance of the mortgage note on that property, up to Lannett s 50% share of the venture. Realty owns the land and building, and Cody leases the building and property from Realty for $15,000 per month. All intercompany rent expense is eliminated upon consolidation with Cody.

The Company is not involved in any other VIE of which Lannett is the primary beneficiary.

Note 17. Related Party Transactions

The Company had sales of approximately $213,000 and $167,000 during the three months ended September 30, 2009 and 2008, respectively, to a generic distributor, Auburn Pharmaceutical Company. Jeffrey Farber (the related party), who is a current board member and the son of the Chairman of the Board of Directors and principal shareholder of the Company, William Farber, is the owner of Auburn Pharmaceutical Company. Accounts receivable includes amounts due from the related party of approximately $133,000 and $125,000 at September 30, 2009 and June 30, 2009, respectively. In the Company s opinion, the terms of these transactions were not more favorable to the related party than would have been to a non-related party.

In January 2005, Lannett Holdings, Inc. entered into an agreement in which the Company purchased for $100,000 and future royalty payments the proprietary rights to manufacture and distribute a product for which Pharmeral, Inc. owned the ANDA. In Fiscal 2008, the Company obtained FDA approval to use the proprietary rights. Accordingly, the Company originally capitalized these rights as an indefinite lived intangible asset and tested this asset for impairment at least on an annual basis. During the fourth quarter of Fiscal 2009, it was determined that this intangible asset no longer has an indefinite life. No impairment existed because the estimated fair value exceeded the carrying amount on that date. Accordingly, the $100,000 carrying amount of this intangible asset is being amortized on a straight line basis prospectively over its 10 year remaining estimated useful life.

Arthur Bedrosian, President and Chief Executive Officer, currently owns 100% of Pharmeral, Inc. This transaction was approved by the Board of Directors of the Company and in their opinion the terms were not more favorable to the related party than they would have been to a non-related party. In May 2008, Mr. Bedrosian and Pharmeral waived their rights to any royalty payments on the sales of the drug by Lannett under Lannett s current ownership structure. Should Lannett undergo a change in control transaction with a third party, this royalty would be

reinstated.

Table of Contents

Provell Pharmaceuticals, LLC (Provell) is a joint venture to distribute pharmaceutical products through mail order outlets. In exchange for access to Lannett s drug providers, Lannett initially received a 33% ownership interest in this venture. Lannett s ownership interest subsequently decreased to 25% due to the additional issuance of shares by Provell in which Lannett did not participate. The investment is valued at zero, due to losses incurred to date by Provell. During June 2009, the Company terminated its participation in this joint venture. In connection with the termination agreement, the Company is required to pay Provell ten percent of net sales of certain products for a period of up to twenty four months.

Accounts receivable includes amounts due from Provell of approximately zero and $55,000 at September 30, 2009 and June 30, 2009, respectively. The Company recognized revenues from Provell of approximately $75,000 during the three months ended September 30, 2008.

Note 18. Material Contract with Supplier

Jerome Stevens Pharmaceuticals agreement:

The Company s primary finished product inventory supplier is Jerome Stevens Pharmaceuticals, Inc. (JSP), in Bohemia, New York. Purchases of finished goods inventory from JSP accounted for approximately 67% and 75% of the Company s inventory purchases during the three month periods ended September 30, 2009 and 2008, respectively. On March 23, 2004, the Company entered into an agreement with JSP for the exclusive distribution rights in the United States to the current line of JSP products, in exchange for four million (4,000,000) shares of the Company s common stock. The JSP products covered under the agreement included Butalbital, Aspirin, Caffeine with Codeine Phosphate capsules, Digoxin tablets and Levothyroxine Sodium tablets, sold generically and under the brand name Unithroid®. The term of the agreement is ten years, beginning on March 23, 2004 and continuing through March 22, 2014. Both Lannett and JSP have the right to terminate the contract if one of the parties does not cure a material breach of the contract within thirty (30) days of notice from the non-breaching party.

During the term of the agreement, the Company is required to use commercially reasonable efforts to purchase minimum dollar quantities of JSP s products being distributed by the Company. The minimum quantity to be purchased in the first year of the agreement is $15 million. Thereafter, the minimum quantity to be purchased increases by $1 million per year up to $24 million for the last year of the ten-year contract. The Company has met the minimum purchase requirement for the first five years of the contract, but there is no guarantee that the Company will be able to continue to do so in the future. If the Company does not meet the minimum purchase requirements, JSP s sole remedy is to terminate the agreement.

Under the agreement, JSP is entitled to nominate one person to serve on the Company s Board of Directors (the Board) provided, however, that the Board shall have the right to reasonably approve any such nominee in order to fulfill its fiduciary duty by ascertaining that such person is suitable for membership on the board of a publicly traded corporation. Suitability is determined by, but not limited to, the requirements of the Securities and Exchange Commission, the American Stock Exchange, and other applicable laws, including the Sarbanes-Oxley Act of 2002. As of September 30, 2009, JSP has not exercised the nomination provision of the agreement.

The Company s financial condition, as well as its liquidity resources, are very dependent on an uninterrupted supply of product from Jerome Stevens. Should there be an interruption in the supply of product from Jerome Stevens for any reason, this event would have a material impact to the financial condition of Lannett.

Note 19. Subsequent Events

In May 2009, the FASB issued authoritative guidance which defines the period after the balance sheet date during which a reporting entity s management should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements. The Company adopted this authoritative guidance effective with its financial statements as of and for the year ended June 30, 2009. In preparing these financial statements, the Company has evaluated events and transactions for potential recognition or disclosure through November 12, 2009, the date the financial statements were issued.

Table of Contents

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

Introduction

The following information should be read in conjunction with the consolidated financial statements and notes in Part I, Item 1 of this Quarterly Report and with Management s Discussion and Analysis of Financial Condition and Results of Operations contained in the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 2009.

This Report on Form 10-Q and certain information incorporated herein by reference contain forward-looking statements which are not historical facts made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are not promises or guarantees and investors are cautioned that all forward-looking statements involve risks and uncertainties, including but not limited to the impact of competitive products and pricing, product demand and market acceptance, new product development, the regulatory environment, including without limitation, reliance on key strategic alliances, availability of raw materials, fluctuations in operating results and other risks detailed from time to time in the Company s filings with the Securities and Exchange Commission. These statements are based on management s current expectations and are naturally subject to uncertainty and changes in circumstances. We caution you not to place undue reliance upon any such forward-looking statements which speak only as of the date made. Lannett is under no obligation to, and expressly disclaims any such obligation to, update or alter its forward-looking statements, whether as a result of new information, future events or otherwise.

Critical Accounting Policies

The discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amount of assets and liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities at the date of our financial statements. Actual results may differ from these estimates under different assumptions or conditions.

Critical accounting policies are defined as those that are reflective of significant judgments and uncertainties, and potentially result in materially different results under different assumptions and conditions. We believe that our critical accounting policies include those described below.

Consolidation of Variable Interest Entity The Company consolidates any Variable Interest Entity (VIE) of which we are the primary beneficiary. The liabilities recognized as a result of consolidating a VIE do not represent additional claims on our general assets; rather, they represent claims against the specific assets of the consolidated VIE. Conversely, assets recognized as a result of consolidating a VIE do not represent additional assets that could be used to satisfy claims against our general assets. Reflected in the September 30, 2009 and June 30, 2009 balance sheets are consolidated VIE assets of approximately $1.9 million and $1.9 million, respectively, which is comprised mainly of land and a building. VIE liabilities consist of a mortgage on that property in the amount of approximately $1.7 and $1.7 million at September 30, 2009 and June 30, 2009,

Table of Contents

respectively. This VIE was initially consolidated by Cody, as Cody has been the primary beneficiary. Cody has then been consolidated within Lannett s financial statements since its acquisition in April 2007.

Revenue Recognition The Company recognizes revenue when its products are shipped. At this point, title and risk of loss have transferred to the customer and provisions for rebates, promotional adjustments, price adjustments, returns, chargebacks, and other potential adjustments are reasonably determinable. Accruals for these provisions are presented in the consolidated financial statements as rebates, chargebacks and returns payable and as reductions to net sales. The change in the reserves for various sales adjustments may not be proportionally equal to the change in sales because of changes in both the product and the customer mix. Increased sales to wholesalers will generally require additional accruals as they are the primary recipient of chargebacks and rebates. Incentives offered to secure sales vary from product to product. Provisions for estimated rebates and promotional credits are estimated based upon contractual terms. Provisions for other customer credits, such as price adjustments, returns, and chargebacks, require management to make subjective judgments on customer mix. Unlike branded innovator drug companies, Lannett does not use information about product levels in distribution channels from third-party sources, such as IMS and Wolters Kluwer, in estimating future returns and other credits. Lannett calculates a chargeback/rebate rate based on contractual terms with its customers and applies this rate to customer sales. The only variable is customer mix, and this assumption is based on historical data and sales expectations. The chargeback/rebate reserve is reviewed on a monthly basis by management using several ratios and calculated metrics. As we continue to obtain additional information about our historical experience for chargebacks, rebates and returns, we also update our estimates of the required reserves.

Chargebacks The provision for chargebacks is the most significant and complex estimate used in the recognition of revenue. The Company sells its products directly to wholesale distributors, generic distributors, retail pharmacy chains, and mail-order pharmacies. The Company also sells its products indirectly to independent pharmacies, managed care organizations, hospitals, nursing homes, and group purchasing organizations, collectively referred to as indirect customers. Lannett enters into agreements with its indirect customers to establish pricing for certain products. The indirect customers then independently select a wholesaler from which to actually purchase the products at these agreed-upon prices. Lannett will provide credit to the wholesaler for the difference between the agreed-upon price with the indirect customer and the wholesaler s invoice price if the price sold to the indirect customer is lower than the direct price to the wholesaler. This credit is called a chargeback. The provision for chargebacks is based on expected sell-through levels by the Company s wholesale customers to the indirect customers and estimated wholesaler inventory levels. As sales by the Company to the large wholesale customers, such as Cardinal Health, AmerisourceBergen, and McKesson, increase, the reserve for chargebacks will also generally increase. However, the size of the increase depends on the expected mix of product sales to the indirect customers. The Company continually monitors the reserve for chargebacks and makes adjustments when management believes that expected chargebacks on actual sales may differ from the amounts that were assumed in the establishment of the chargeback reserves.

Rebates Rebates are offered to the Company s key chain drug store and wholesaler customers to promote customer loyalty and increase product sales. These rebate programs provide customers with rebate credits upon attainment of pre-established volumes or attainment of net sales milestones for a specified period. Other promotional programs are incentive programs offered to the customers. At the time of shipment, the Company estimates reserves for rebates and other promotional credit programs based on the specific terms in each agreement. The reserve for rebates increases as sales to rebate-eligible customers are recognized and decreases when actual rebate payments are made. However, since rebate programs are not identical for all customers, the size of the reserve will depend on the mix of sales to customers that are eligible to receive rebates.

Returns Consistent with industry practice, the Company has a product returns policy that allows certain customers to return product within a specified period prior to and subsequent to the product s lot expiration date

Table of Contents

in exchange for a credit to be applied to future purchases. The Company s policy requires that the customer obtain pre-approval from the Company for any qualifying return. The Company estimates its provision for returns based on historical experience, adjusted for any changes in business practices or conditions that would cause management to believe that future product returns may differ from those returns assumed in the establishment of reserves. Generally, the reserve for returns increases as sales increase and decrease when credits are issued or payments are made for actual returns received. The reserve for returns is included in the rebates, chargebacks and returns payable account on the balance sheet.

Other Adjustments Other adjustments consist primarily of price adjustments, also known as shelf stock adjustments, which are credits issued to reflect decreases in the selling prices of the Company s products that customers have remaining in their inventories at the time of a price reduction. Decreases in selling prices are discretionary decisions made by management to reflect competitive market conditions. Amounts recorded for estimated shelf stock adjustments are based upon specified terms with direct customers, estimated declines in market prices, and estimates of inventory held by customers. The Company regularly monitors these and other factors and evaluates the reserve as additional information becomes available. Other adjustments are included in the rebates and chargebacks payable account on the balance sheet. When competitors enter the market for existing products, shelf stock adjustments may be issued to maintain price competitiveness.

The following tables identify the reserves for each major category of revenue allowance and a summary of the activity for the three months ended September 30, 2009 and 2008:

For the three months ended September 30, 2009

Reserve Category	Chargebacks	Rebates	Returns	Other	Total
Reserve Balance as of June 30, 2009	$ 6,089,802	$ 2,537,746	$ 5,106,992	$	$ 13,734,540
Actual credits issued related to sales recorded in prior fiscal years	(4,767,581)	(1,852,708)	(1,147,720)		(7,768,009)
Reserves or (reversals) charged during Fiscal 2010 related to sales in prior fiscal years					
Reserves charged to net sales during Fiscal 2010 related to sales recorded in Fiscal 2010	10,272,936	4,066,855	1,140,128	407,784	15,887,703
Actual credits issued related to sales recorded in Fiscal 2010	(7,000,389)	(1,789,955)		(407,784)	(9,198,128)
Reserve Balance as of September 30, 2009	$ 4,594,768	$ 2,961,938	$ 5,099,400	$	$ 12,656,106

For the three months ended September 30, 2008

Reserve Category	Chargebacks	Rebates	Returns	Other	Total
Reserve Balance as of June 30, 2008	$ 4,049,407	$ 632,314	$ 13,642,589	$ 2,107	$ 18,326,417
Actual credits issued related to sales recorded in prior fiscal years	(2,865,229)	(255,126)	(6,425,413)		(9,545,768)
Reserves or (reversals) charged during Fiscal 2009 related to sales in prior fiscal			2,107	(2,107)	

years					
Reserves charged to net sales during Fiscal 2009 related to sales recorded in Fiscal 2009	9,144,349	2,949,913	1,142,474	42,957	13,279,693
Actual credits issued related to sales recorded in Fiscal 2009	(5,129,939)	(1,537,556)		(40,096)	(6,707,591)
Reserve Balance as of September 30, 2008	$ 5,198,588	$ 1,789,545	$ 8,361,757	$ 2,861	$ 15,352,751

The total reserve for chargebacks, rebates, returns and other adjustments decreased from $13,734,540 at June 30, 2009 to $12,656,106 at September 30, 2009. As of September 30, 2009 approximately $9,924,000 of the

Table of Contents

original $10,545,000 return reserve recorded in Fiscal 2008 for Prenatal Multivitamin was applied to accounts receivable for customers who had returned the Prenatal Multivitamin product by that date, leaving a balance of approximately $621,000 of Multivitamin returns reserve on the books at September 30, 2009. The decrease in chargeback reserves between June 30, 2009 and September 30, 2009 was due primarily to a decrease in inventory levels at wholesaler distribution centers.

Credits issued during the quarter that relate to prior year sales are charged against the opening balance. In aggregate, additional reserves or reversals of reserves have historically offset each other. The table above shows the effects of reversals within the rebates, returns and other categories. It is the Company s intention that all reserves be charged to sales in the period that the sale is recognized, however, due to the nature of this estimate, it is possible that the Company may sometimes need to increase or decrease the reserve based on prior period sales. If that were to occur, management would disclose that information at that time. If the historical data the Company uses and the assumptions management makes to calculate its estimates of future returns, chargebacks, and other credits do not accurately approximate future activity, its net sales, gross profit, net income and earnings per share could change. However, management believes that these estimates are reasonable based upon historical experience and current conditions.

The rates of reserves will vary, as well as the category under which the credit falls. This variability comes about when the Company is working with indirect customers to compete with the pricing of other generic companies. The Company has improved its computer systems in order to improve the accuracy of tracking and processing chargebacks and rebates and will continue to look at ways for further improvements. Improvements to automate calculation of reserves will not only reduce the potential for human error, but also will result in more in-depth analysis and improved customer interaction for resolution of open credits.

The rate of credits issued is monitored by the Company at least on a quarterly basis. The Company may change the estimate of future reserves based on the amount of credits processed, or the rate of sales made to indirect customers. The decrease of reserves to $12,656,106 at September 30, 2009 from $13,734,540 at June 30, 2009 is due to the timing of credits being processed by the customers and by the Company. Approximately $7,768,000 or 57% of the reserve balance from June 30, 2009 has been processed through the first three months of Fiscal 2010. Approximately $207,000 of that amount relates to credits issued due to the return by customers of the Prenatal Multivitamin product through September 30, 2009. Management estimates reserves based on sales mix. A comparison to wholesaler inventory reports is performed quarterly, in order to justify the balance of unclaimed chargebacks and rebates. The Company has historically found a direct correlation between the calculation of the reserve based on sales mix, and the wholesaler inventory analysis.

Table of Contents

Accounts Receivable The Company performs ongoing credit evaluations of its customers and adjusts credit limits based upon payment history and the customer s current credit worthiness, as determined by a review of current credit information. The Company continuously monitors collections and payments from its customers and maintains a provision for estimated credit losses based upon historical experience and any specific customer collection issues that have been identified. While such credit losses have historically been within both the Company s expectations and the provisions established, the Company cannot guarantee that it will continue to experience the same credit loss rates that it has in the past.

The Company also regularly monitors accounts receivable (AR) balances by reviewing both net and gross day s sales outstanding (DSO). Net DSO is calculated by dividing gross accounts receivable less the reserve for rebates, chargebacks, returns and other adjustments by the average daily net sales for the period. Gross DSO shows the result of the same calculation without regard to rebates, chargebacks, returns and other adjustments.

The Company monitors both net DSO and gross DSO as an overall check on collections and to assess the reasonableness of the reserves. Gross DSO provides management with an understanding of the frequency of customer payments, and the ability to process customer payments and deductions. The net DSO calculation provides management with an understanding of the relationship of the AR balance net of the reserve liability compared to net sales after charges to the reserves during the period. Standard payment terms offered to customers are consistent with industry practice at 60 days. Net eliminates the effect of timing of processing, which is inherent in the gross DSO calculation.

The following table shows the results of these calculations as of the relevant periods:

	9/30/09	6/30/09	9/30/08
Net DSO (in days)	68	55	38
Gross DSO (in days)	62	53	61

The level of both net and gross DSO at September 30, 2009 is within the Company s expectation that DSO will be in the 60 to 70 day range based on 60 day payment terms for most customers.

Inventories The Company values its inventory at the lower of cost (determined by the first-in, first-out method) or market, regularly reviews inventory quantities on hand, and records a provision for excess and obsolete inventory based primarily on estimated forecasts of product demand and production requirements. The Company s estimates of future product demand may prove to be inaccurate, in which case it may have understated or overstated the provision required for excess and obsolete inventory. In the future, if the Company s inventory is determined to be overvalued, the Company would be required to recognize such costs in cost of goods sold at the time of such determination. Likewise, if inventory is determined to be undervalued, the Company may have recognized excess cost of goods sold in previous periods and would be required to recognize such additional operating income at the time of sale.

Results of Operations - Three months ended September 30, 2009 compared with three months ended September 30, 2008

Net sales for the three months ended September 30, 2009 (Fiscal 2010) increased 23% to $31,435,000 from $25,568,000 for the three months ended September 30, 2008 (Fiscal 2009). The increase was primarily due to sales of drugs used for pain management totaling $2,880,000 as well as sales of $1,489,000 of our prescription

Table of Contents

vitamins during the first quarter of Fiscal 2010. The following factors also contributed to the $5,867,000 increase in sales:

Medical indication	Sales volume change %	Sales price change %
Heart Failure	-30%	11%
Antibiotics	24%	-8%
Epilepsy	-16%	17%
Thyroid Deficiency	15%	- 1%
Pain Management	480%	37%
Migraine Headache	%	15%

The increase in product sales can be attributed primarily to four products. Sales of drugs used for pain management increased by approximately $2,604,000 in the first quarter of Fiscal 2010 compared to the first quarter of Fiscal 2009 due to a market withdrawal by one of our major competitors. Sales of drugs used in the treatment of thyroid deficiency increased by approximately $1,558,000 as a result of a continued shift away from branded drugs towards generic prescriptions. Partially offsetting these increases was a decrease in sales of drugs for the treatment of congestive heart failure by approximately $1,496,000 in the first quarter of Fiscal 2010 compared to the first quarter of Fiscal 2009. This decrease was due to a product recall by several of our major competitors which increased our first quarter of Fiscal 2009 revenues. The increase in sales can also be attributed to the continued sales of our prescription vitamins discussed above.

The Company expects to continue increasing the number of products available for sale to its customers, which will require additional FDA approvals. The Company s receipt of several approvals by the FDA to offer new products has resulted in more sales of new products in Fiscal 2010 compared to Fiscal 2009.

The Company sells its products to customers in various categories. The table below identifies the Company s approximate net sales to each category for the three months ended September 30, 2009 and 2008:

Customer Category	2009	2008
Wholesaler/ Distributor	$ 15,169,000	$ 11,841,000
Retail Chain	14,732,000	11,975,000
Mail-Order Pharmacy	1,534,000	1,636,000
Private Label		116,000
Total	$ 31,435,000	$ 25,568,000

The sales to wholesaler/distributor and retail chain customer categories increased significantly as a result of an increase in the demand for products for which the Company is the major supplier and also an increase in the number of products available for sale.

Cost of sales for the first quarter increased 20% to $19,901,000 in Fiscal 2010 from $16,566,000 in Fiscal 2009. The increase reflected the impact of the 23% increase in sales and royalties of approximately $440,000 primarily related to the prescription vitamins. The increase in cost of sales was less than the increase in sales, however, due to the fixed nature of some production costs.

Amortization expense primarily relates to the JSP Distribution Agreement. For the remaining five years of the JSP Distribution Agreement, the Company will incur annual amortization expense of approximately $1,785,000.

Table of Contents

Gross profit margins for the first quarter of Fiscal 2010 and Fiscal 2009 were 37% and 35%, respectively. Gross profit percentage increased due to strong profit margins on the pain management products and prescription vitamins, as well as the fixed nature of some production costs. While the Company is continuously striving to keep product costs low, there can be no guarantee that profit margins will not fluctuate in future periods. Pricing pressure from competitors and costs of producing or purchasing new drugs may also fluctuate in the future. Changes in the future sales product mix may also occur. These changes may affect the gross profit percentage in future periods.

Research and development (R&D) expenses in the first quarter increased 63% to $3,028,000 for Fiscal 2010 from $1,863,000 for Fiscal 2009. The increase is primarily due to an increase in production of drugs in development and preparation for submission to the FDA as well as increased costs for biostudies. The Company expenses all production costs as R&D until the drug is approved by the FDA. R&D expenses may fluctuate from period to period, based on R&D plans for submission to the FDA.

Selling, general and administrative expenses in the first quarter decreased 24% to $3,763,000 in Fiscal 2010 from $4,949,000 in Fiscal 2009. The decrease is primarily due to litigation expenses in Fiscal 2009 related to the patent challenge with KV Pharmaceuticals of approximately $800,000 which were not incurred in Fiscal 2010. While the Company is focused on controlling costs, increases in personnel costs may have an ongoing and longer lasting impact on the administrative cost structure. Other costs are being incurred to facilitate improvements in the Company s infrastructure. These costs are expected to be temporary investments in the future of the Company and may not continue at the same level.

Interest expense was flat with $70,000 recorded in the first quarter of Fiscal 2010 compared to $66,000 in Fiscal 2009. Interest income in the first quarter decreased to $23,000 in Fiscal 2010 from $46,000 in Fiscal 2009 due to lower interest earned on investment securities.

The Company recorded income tax expense in the first quarter of 2010 of $1,828,000 compared to $920,000 in the first quarter of Fiscal 2009. The effective tax rate for the three months ended September 30, 2009 was 39%, compared to 43% for the three months ended September 30, 2008. The effective tax rate for the three months ended September 30, 2009 was a lower effective tax rate compared to September 30, 2008 due primarily to a change in the Federal rate from the 35% statutory rate to an estimated 34% actual rate, apportionment of income to Wyoming which has no state income tax, and federal income tax credits.

The Company reported net income of approximately $2,857,000 in the first quarter of Fiscal 2010, or $0.12 basic and $0.11 diluted earnings per share, as compared to $1,226,000 in the first quarter Fiscal 2009, or $0.05 basic and diluted earnings per share.

Liquidity and Capital Resources

The Company has historically financed its operations with cash flow generated from operations, supplemented with borrowings from various government agencies and financial institutions. At September 30, 2009, working capital was $42,266,000, as compared to $38,632,000 at June 30, 2009, an increase of $3,634,000.

Net cash used in operating activities of $634,000 in the first three months of Fiscal 2010 reflected net income of $2,857,000, after adjusting for non-cash items of $1,837,000, as well as cash used by changes in operating assets and liabilities of $5,328,000. Significant changes in operating assets and liabilities are comprised of:

- An increase in trade accounts receivable of $1,152,000 primarily as a result of increased sales in Fiscal 2010. The change in the accounts receivable balance from June 30, 2009 to September 30, 2009 includes a non-cash decrease of approximately $207,000 related to the issuance of credits for the returns of the multivitamin product received by the Company through September 30, 2009.

- An increase in inventories of $815,000 due to increased stocking levels at both Lannett and Cody Labs for several products as of September 30, 2009 that are being carried in order to respond to the increased order volume we are currently experiencing.

Table of Contents

- An increase in income taxes payable of $514,000 related to Fiscal 2010 taxable income.

- A decrease in accounts payable of $1,156,000 due to the timing of payments at the end of the month.

- A decrease in rebates, chargebacks and returns payable of $872,000 primarily as a result of a decrease in the chargeback reserve due to lower inventory levels at wholesaler distribution centers offset by a non-cash decrease of approximately $207,000 related to the issuance of credits for the returns of the multivitamin product received by the Company through September 30, 2009.

- A decrease in accrued payroll and payroll related costs of $2,195,000 primarily related to the partial payment of the Fiscal 2009 accrued incentive compensation costs totaling approximately $3,000,000.

Net cash used in investing activities of $1,567,000 for the three months ended September 30, 2009 reflected the purchase of property, plant and equipment of $1,067,000 as well as the purchase of an intangible asset (product rights) for $500,000.

Net cash used in financing activities of $19,000 for the three months ended September 30, 2009 was primarily due to scheduled debt repayments of $136,000. Proceeds from the issuance of stock of $186,000 were partially offset by the purchase of treasury stock totaling $69,000.

Long-term debt amounts due, for the twelve month periods ended September 30 are as follows:

Twelve Month Periods		Amounts Payable to Institutions
2010	$	357,806
2011		4,818,102
2012		274,802
2013		283,934
2014		279,293
Thereafter		1,988,546
	$	8,002,483

The Company has a $3,000,000 line of credit from Wachovia Bank, N.A. (Wachovia) that bears interest at the prime interest rate less 0.25% (2.75% and 3.00% at September 30 and June 30, 2009, respectively). As of September 30 and June 30, 2009, the Company has $3,000,000 of availability under this line of credit. The line of credit is collateralized by substantially all of the Company s assets.

The existing line of credit which was scheduled to expire on November 30, 2009, was renewed and extended during the first quarter of Fiscal 2010 to November 30, 2010. As part of the renewal agreement, the Company is no longer required to maintain any minimum deposit balances with Wachovia, and the availability fee on the unused balance of the line of credit was reduced to 0.375%.

Table of Contents

The terms of the line of credit, the loan agreement and the related letter of credit require that the Company meet certain financial covenants and reporting standards, including the attainment of standard financial liquidity and net worth ratios. As of September 30, 2009, the Company is in compliance with all financial covenants under the agreement.

In July 2004, the Company received $500,000 of grant funding from the Commonwealth of Pennsylvania, acting through the Department of Community and Economic Development. The grant funding program requires the Company to use the funds for machinery and equipment located at their Pennsylvania locations, hire an additional 100 full-time employees by June 30, 2006, operate its Pennsylvania locations a minimum of five years and meet certain matching investment requirements. If the Company fails to comply with any of the requirements above, the Company would be liable to repay the full amount of the grant funding ($500,000). The Company has recorded the unearned grant funds as a liability until the Company complies with all of the requirements of the grant funding program. Through September 30, 2009, the Company has had preliminary discussions with the Commonwealth of Pennsylvania to determine whether it will be required to repay any of the funds provided under the grant fund. Based on information available at September 30, 2009, the Company has recorded the grant funding as a long-term liability under the caption of Unearned Grant Funds. Except as set forth in this report, the Company is not aware of any trends, events or uncertainties that have or are reasonably likely to have a material adverse impact on the Company s short-term or long-term liquidity or financial condition.

Prospects for the Future

The Company has several generic products under development. These products are all orally-administered, topical and parenteral products designed to be generic equivalents to brand named innovator drugs. The Company s developmental drug products are intended to treat a diverse range of indications. As one of the oldest generic drug manufacturers in the country, formed in 1942, Lannett currently owns several ANDAs for products which it does not manufacture and market. These ANDAs are dormant on the Company s records. Occasionally, the Company reviews such ANDAs to determine if the market potential for any of these older drugs has recently changed, so as to make it attractive for Lannett to reconsider manufacturing and selling it. If the Company makes the determination to introduce one of these products into the consumer marketplace, it must review the ANDA and related documentation to ensure that the approved product specifications, formulation and other factors meet current FDA requirements for the marketing of that drug. The Company would then redevelop the product and submit it to the FDA for supplemental approval. The FDA s approval process for ANDA supplements is similar to that of a new ANDA. Generally, in these situations, the Company must file a supplement to the FDA for the applicable ANDA, informing the FDA of any significant changes in the manufacturing process, the formulation, or the raw material supplier of the previously-approved ANDA.

A majority of the products in development represent either previously approved ANDAs that the Company is planning to reintroduce (ANDA supplements), or new formulations (new ANDAs). The products under development are at various stages in the development cycle formulation, scale-up, and/or clinical testing. Depending on the complexity of the active ingredient s chemical characteristics, the cost of the raw material, the FDA-mandated requirement of bioequivalence studies, the cost of such studies and other developmental factors, the cost to develop a new generic product varies and can range from $100,000 to $1.5 million. Some of Lannett s developmental products will require bioequivalence studies, while others will not depending on the FDA s Orange Book classification. Since the Company has no control over the FDA review process, management is unable to anticipate whether or when it will be able to begin producing and shipping additional products.

The Company views its April 2007 acquisition of Cody Laboratories, Inc. (Cody Labs or Cody) as an important step in becoming a vertically integrated narcotics manufacturer and distributor by allowing it to concentrate on developing and completing its dosage form manufacturing in order to reduce narcotic API costs.

Table of Contents

In July 2008, the DEA granted Cody Labs a license to directly import raw poppy straw for conversion into API and/or various pharmaceutical products. Only six other companies in the U.S. have been granted this license to date. This license allows the Company to avoid increased costs associated with buying narcotic API from other manufacturers. The Company anticipates that it can use this license to become a vertically integrated manufacturer of narcotic products, as well as a supplier of API to the pharmaceutical industry. The Company believes that the aging domestic population may result in a higher demand for pain management pharmaceutical products and that it will be well-positioned to take advantage of this increased demand.

Cody Labs manufacturing expertise in narcotic APIs will allow Lannett to build a market with limited domestic competition. The Company anticipates that the demand for narcotics and controlled drugs will continue to grow with the Baby Boomer generation demographics and that it is well-positioned to take advantage of these opportunities by concentrating additional resources in the narcotic area.

In addition to the efforts of its internal product development group, Lannett has contracted with several outside firms for the formulation and development of several new generic drug products. These outsourced R&D products are at various stages in the development cycle formulation, analytical method development and testing and manufacturing scale-up. These products are orally-administered solid dosage products, topical or parenterals intended to treat a diverse range of medical indications. We intend to ultimately transfer the formulation technology and manufacturing process for all of these R&D products to our own commercial manufacturing sites. The Company initiated these outsourced R&D efforts to complement the progress of its own internal R&D efforts.

Occasionally, the Company will work on developing a drug product that does not require FDA approval. Certain prescription drugs do not require prior FDA approval before marketing. They include, for instance, drugs listed as DESI drugs (Drug Efficacy Study implementation) which are under evaluation by FDA, Grandfathered Drugs, and prescription multivitamin drugs. A generic manufacturer may sell products which are chemically equivalent to innovator drugs, under FDA rules by simply performing and internally documenting the normal research and development involved in bringing a new product to market. Under this scenario, a generic company can forego the time required for FDA approval.

More specifically, certain products, marketed prior to the Federal Food, Drug and Cosmetic Act may be considered GRASE or Grandfathered. GRASE products are those old drugs that do not require prior approval from FDA in order to be marketed because they are generally recognized as safe and effective based on published scientific literature. Similarly, Grandfathered products are those which entered the market before the passage of the 1938 act or the 1962 amendments to the act. Under the grandfather clause, such a product is exempted from the effectiveness requirements [of the act] if its composition and labeling have not changed since 1962 and if, on the day before the 1962 amendments became effective, it was (1) used or sold commercially in the United States, (2) not a new drug as defined by the act at that time, and (3) not covered by an effective application.

The Company has entered supply and development agreements with certain international companies, including Wintac of India, Orion Pharma of Finland, Azad Pharma AG and Swiss Caps of Switzerland, Pharma 2B (formerly Pharmaseed) of Israel, as well as certain domestic companies, including Banner Pharmacaps, Cerovene and Inverness. The Company is currently in negotiations on similar agreements with other international companies, through which Lannett will market and distribute products manufactured by Lannett or by third parties. Lannett intends to use its strong customer relationships to build its market share for such products, and increase future revenues and income.

The majority of the Company s R&D projects are being developed in-house under Lannett s direct supervision and with Company personnel. Hence, the Company does not believe that its outside contracts for product

Table of Contents

development and manufacturing supply are material in nature, nor is the Company substantially dependent on the services rendered by such outside firms.

Lannett may increase its focus on certain specialty markets in the generic pharmaceutical industry. Such a focus is intended to provide Lannett customers with increased product alternatives in categories with relatively few market participants. While there is no guarantee that Lannett has the market expertise or financial resources necessary to succeed in such a market specialty, management is confident that such future focus will be well received by Lannett customers and increase shareholder value in the long run.

The Company plans to enhance relationships with strategic business partners, including providers of product development research, raw materials, active pharmaceutical ingredients as well as finished goods. Management believes that mutually beneficial strategic relationships in such areas, including potential financing arrangements, partnerships, joint ventures or acquisitions, could allow for potential competitive advantages in the generic pharmaceutical market. The Company plans to continue to explore such areas for potential opportunities to enhance shareholder value.

Table of Contents

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company has debt instruments with variable interest rates. The Company has a $3,000,000 line of credit from Wachovia Bank, N.A. (Wachovia) that bears interest at the prime interest rate less 0.25% (2.75% and 3.00% at September 30 and June 30, 2009, respectively). As of September 30 and June 30, 2009, the Company has $3,000,000 of availability under this line of credit. The line of credit is collateralized by substantially all of the Company s assets. The agreement contains covenants with respect to working capital, net worth and certain ratios, as well as other covenants. The existing line of credit which was to expire on November 30, 2009, was renewed and extended to November 30, 2010.

The Company invests in U.S. treasury notes, and government asset-backed securities, all of which are exposed to interest rate fluctuations. The interest earned on these investments may vary based on fluctuations in the interest rate.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

As of the end of the period covered by this Form 10-Q, management performed, with the participation of our Chief Executive Officer and Chief Financial Officer, an evaluation of the effectiveness of our disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended (the Exchange Act). Our disclosure controls and procedures are designed to provide reasonable assurance that information required to be disclosed in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosures.

Based upon the evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company s disclosure controls and procedures were effective as of the end of the period covered by this report.

Change in Internal Control Over Financial Reporting

There has been no change in the Company s internal control over financial reporting during the three months ended September 30, 2009 that has materially affected, or reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In early June 2008, the Company filed a declaratory judgment suit in the Federal District Court of Delaware (Civil Action No. 08-338 (JJF)) against KV Pharmaceuticals, DrugTech Corp., and Ther-Rx Corp (collectively KV). The complaint sought declaratory judgment for non-infringement and invalidity of certain patents owned by KV. The complaint further sought declaratory judgment of anti-trust violations and federal and state unfair competition violations for actions taken by KV in securing and enforcing these patents. After the complaint was filed, KV countered with a motion for a Temporary Restraining Order (TRO) to prevent the Company from launching its Multivitamin with Mineral Capsules (MMCs), due to alleged patent and trademark infringement issues. The TRO was heard and, ultimately, resulted in a conclusion by the court that the Company s product label on the MMCs should be modified. KV also countered with claims of infringement by the Company of KV s patents seeking the Company s profits for sales of MMCs or other monetary relief, preliminary and permanent injunctive relief, attorney s fees and a finding of willful infringement. On March 17, 2009 the Company and KV settled the litigation. In light of the withdrawal of KV s innovator prenatal product, and the resulting anticipated decline in sales and declining market for written prescription, the Company decided it was pointless to continue the litigation and entered into the settlement arrangement with KV. Pursuant to the settlement, the Company will receive a license from KV and will become an authorized generic provider. During the terms of the license, the Company will pay KV a royalty on all future sales of its Prenatal vitamin product. Lannett will cease offering its Prenatal vitamin product if and when the brand is restored to the marketplace.

In or about July 2008, Albion International and Albion, Inc. filed suit in the United States District Court, District of Utah (Case No. 2:08cv00515) against Lannett asserting claims for patent and trademark infringement, as well as unfair competition, arising out of Lannett s use of product that it purchased from Albion and used as an ingredient in its MMC. Lannett filed a motion to dismiss the complaint on the basis that it purchased the product from Albion and, as such, was authorized to use the product in its MMC. The Court granted the motion and dismissed the complaint but gave Albion leave to file an amended complaint. On January 20, 2009, Albion filed an amended complaint. Lannett filed an answer to the complaint and counterclaim, asserting, among other things, that Albion tortuously interfered with Lannett s contracts. Subsequent to the filing of the answer and counterclaim, Lannett and Albion reached an agreement in principal to settle the case. Under terms of the settlement, the parties would each dismiss their claims against each other and provide releases. On July 6, 2009, the settlement agreement was signed and on July 13, 2009 the case was dismissed.

Regulatory Proceedings

The Company is engaged in an industry which is subject to considerable government regulation relating to the development, manufacturing and marketing of pharmaceutical products. Accordingly, incidental to its business, the Company periodically responds to inquiries or engages in administrative and judicial proceedings involving regulatory authorities, particularly the FDA and the Drug Enforcement Agency.

Table of Contents

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters have been submitted to a vote of the Company s security holders during the quarter ended September 30, 2009.

ITEM 6. EXHIBITS

(a) A list of the exhibits required by Item 601 of Regulation S-K to be filed as a part of this Form 10-Q is shown on the Exhibit Index filed herewith.

Table of Contents

SIGNATURE

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

LANNETT COMPANY, INC.

Dated: November 12, 2009	By:	/s/ Keith R. Ruck Keith R. Ruck Vice President of Finance and Chief Financial Officer
Dated: November 12, 2009	By:	/s/ Arthur P. Bedrosian Arthur P. Bedrosian President and Chief Executive Officer

Table of Contents

Exhibit Index

31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Filed Herewith
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Filed Herewith
32	Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Filed Herewith